STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6959

Investigation into a Successor Incentive Regulation Plan for Verizon New England Inc., d/b/a Verizon Vermont	))	Hearings at Montpelier, Vermont January 31, February 1–3 April 26–29, 2005

Proposed Order issued: 7/21/2005

PRESENT: Michael H. Dworkin, Board Chairman
David C. Coen, Board Member
John D. Burke, Board Member

APPEARANCES: *See Appendix A*

PROPOSED ORDER

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I. BACKGROUND AND OVERVIEW

A. Introduction

In this Proposed Order, the Public Service Board ("Board") sets out the terms and conditions of an Incentive Regulation Plan (the "2005–2008 Plan") for Verizon New England Inc., d/b/a Verizon Vermont ("Verizon" or the "Company").[1] Like the alternative regulation plan that it replaces, the Plan we set out in this Proposed Order provides Verizon[2] both the incentives and the regulatory flexibility to deploy new services and technologies, extend broadband services to presently unserved areas, and respond to changes in the marketplace rapidly. It also continues important protections for Vermont consumers, including service quality standards and restrictions on Verizon's ability to increase prices for existing services. Finally, the Plan continues standards to assure that Verizon cannot use its pricing flexibility to unfairly compete against other carriers.

Verizon, the largest local exchange carrier in the state of Vermont, has operated under an Incentive Regulation Plan since 2000.[3] In 2004, Verizon submitted a proposed alternative regulation plan (which it referred to as the "Alternative Form of Regulation" or "AFOR" Plan) to replace this now-expiring plan. Verizon's proposal would allow it significant pricing flexibility, including the ability to raise prices 10 percent annually, and would eliminate standards to preserve service quality. The Department of Public Service (the "Department" or "DPS") has proposed an alternative that is similar to the Incentive Regulation Plan that is now expiring and

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1. Section 226b(f) of Title 30 requires that, if the Board adopts an alternative regulation plan that differs from that proposed by a local exchange carrier ("LEC"), the Board must issue a Proposed Order and permit parties to comment and request further hearings before adopting a final plan. Parties may submit comments on this Proposed Order by August 8, 2005. The Board will hear Oral Argument on these comments on August 11, 2005. Unless a party requests, and the Board convenes, further hearings, the Board will issue the final Order in this docket by September 19, 2005.

2. Throughout this Order, references to Verizon refer to Verizon Vermont, unless the Order specifies otherwise or the context makes it clear that the reference is to Verizon Corporation.

3. That Plan was scheduled to expire on April 24, 2005, although Verizon and the Department of Public Service ("Department") have agreed to extend it through June 30, 2005. These parties also agreed that the successor plan set out in this Proposed Order will take effect retroactive to July 1, 2005.

which provides Verizon with incentives to extend broadband service to new areas and improve network reliability.[4]

We have considered the merits of both proposals and weighed them against the statutory criteria set out in Section 226b(c) of Title 30, including the requirement that it promotes the general good of the state. In addition, we have considered, as we must, the option of adopting no incentive regulation plan, in which case Verizon would revert to traditional cost-of-service regulation. Ultimately, we reach the same conclusion we did five years ago; with appropriate conditions necessary to protect consumers and meet the criteria of 30 V.S.A. § 226b, alternative regulation has potential benefits to Vermont ratepayers.[5]

The proposals the Department and Verizon presented have significant differences, which stem largely from two issues: (1) the adequacy of the current competitive environment to keep prices reasonable and service quality high; and (2) whether the Board should examine Verizon's rates at the outset of the Plan and require rate changes. In simple terms, Verizon contends that competition is sufficient to prevent Verizon from increasing its rates beyond levels that are just and reasonable and that competition will force Verizon to preserve high service quality. Verizon also asserts that examination of rates is inappropriate in the context of alternative regulation, in part because it undermines the incentives the alternative regulation was intended to create. The Department argues that competition at the present time is insufficient to prevent Verizon from increasing its prices, particularly for less competitive services, and that competition is insufficient to prevent Verizon from allowing service quality to deteriorate. In addition, the Department maintains that rate reductions at the outset of the incentive regulation plan are necessary to ensure that alternative regulation is superior to cost-of-service regulation (under which such rate reductions would be required).

We recognize that some telecommunications competition has emerged in the state of Vermont. The evidence does not, however, support the conclusion that this competition is adequate to keep prices to just and reasonable levels. Competition from facilities-based carriers is not sufficiently robust to prevent rate increases. Cross-platform competition from wireless

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4. Lightship Telecom, LLC ("Lightship") has opposed Verizon's proposal.

5. This Proposed Order incorporates in Attachment B the incentive regulation plan that we intend to adopt.

carriers and Voice over Internet Protocol ("VoIP") are starting to make some inroads, but Verizon remains by far the dominant participant in the market. We find no basis on which to conclude that these competitors can prevent Verizon from increasing its prices, particularly for the least elastic services, such as basic rates. Indeed, Verizon's request for unilateral authority to *raise* rates under its proposed plan is clearly contrary to its contention that competition, alone, will constrain pricing. Similarly, this competition appears inadequate to insure high service quality; despite increasing competition. In fact, the record clearly shows that Verizon's service quality deteriorated during the term of the existing plan, an event that is totally inconsistent with Verizon's claim that competitive pressure, alone, will protect service quality.

We also concur with the Department that we must consider Verizon's revenue levels at the time we evaluate the renewal (or extension) of an alternative regulation plan. Failure to make such an assessment could result in ratepayers paying higher rates under incentive regulation than they would if we resumed cost-of-service review; this is critical to our overall determination because, unless ratepayers derive significant benefits from the alternative regulation plan, it would not promote the general good to pay higher than necessary rates.

The 2005–2008 Plan set out in today's Proposed Order reflects our conclusions on these fundamental issues. The Plan contains the following basic elements:

- Traditional rate-of-return regulation is replaced by price regulation in which Verizon may not increase rates for existing services during the term of the Plan. Verizon is free to propose such rate reductions as it chooses or introduce new services (with no restrictions on pricing), subject to price floors established in Dockets 5713 and 6077.
- At the outset of the Plan, Verizon must reduce its annualized retail rates by $8.18 million, by reducing business local exchange service rates and message toll service rates.[6] We also find that small rate decreases are appropriate in future years, directed towards residential service rates. Verizon may avoid these rate decreases if it elects to expand its broadband services to customers and areas that now have no broadband option and to which it would not otherwise offer broadband service.

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6. The $8.18 million overearnings calculation assumes that Verizon elects to separate the Yellow Pages from the white pages as specified in the Proposed Order. In Section III.A.1. of this Proposed Order, we accept the Company's assertion that its Yellow Pages operation is now separate. To assure this separation, the Company should publish, distribute and market Yellow Pages separately from the white pages. If Verizon chooses to continue publishing and distributing the yellow and white directories together, the annual rate reductions increase by $7 million.

- The Board expects that Verizon will make further price reductions during the term of the Plan to reflect known cost shifts and respond to competition. The Board retains the jurisdiction to monitor the plan and ensure that such price changes occur.
- The Plan continues the existing service quality standards (with minor changes), enforced through financial incentives, which will ensure continued high quality telecommunications service for Vermont consumers.
- Verizon will receive significant discretion to deploy new services without prior Board review, allowing the Company to more rapidly respond to market forces.

Collectively, these features of the Incentive Regulation Plan will benefit Verizon's Vermont ratepayers, Verizon's competitors, and the Company itself. Ratepayers benefit from either lower rates or expanded broadband services. The competitive environment is enhanced through Verizon's increased flexibility to offer new services rapidly. At the same time, the 2005–2008 Plan protects competitors, by requiring Verizon to adhere to price floors and other rules designed to facilitate competition.

If Verizon continues to provide high value service to Vermonters, then it will, for the term of the Plan, be free from direct review of its earnings; this will provide the Company with incentives to operate efficiently and the opportunity to benefit from that efficiency. As we did five years ago, we expect earnings freedom and marketing technology will encourage Verizon to deploy new technology, including that necessary to offer broadband services, and to introduce new services that will enhance its earnings.

B. Procedural History

On March 24, 2000, in Docket No. 6167, the Board adopted an Incentive Regulation Plan ("Plan") for Verizon.[7] The Plan had a term of five years and was scheduled to expire on April 22, 2005. At the recommendation of the Department of Public Service ("Department"), on May 13, 2004, the Board opened this proceeding to consider a successor Plan for Verizon.

On June 4, 2004, the Board held a prehearing conference in this docket. Appearances were entered by Peter H. Zamore, Esq., of Sheehey Furlong & Behm, P.C., and Linda M. Ricci, Esq., on behalf of Verizon, and Sarah Hofmann, Esq., and John Cotter, Esq., on behalf of the

7. Docket No. 6167, Order of March 24, 2000.

Department. At the prehearing conference the Board set a schedule for the remainder of the docket and outlined several issues likely to be relevant to the proceeding.

On June 7, 2004, Verizon and the Department entered into a protective agreement establishing procedures relating to allegedly confidential information. The Board issued an Order approving the agreement on July 22, 2004.

Requests to intervene in the docket were filed by AT&T Communications of New England, Inc., National Mobile Communications Corporation, d/b/a SoVerNet Communications, and Lightship Telecom, LLC ("Lightship") on July 27, August 4, and August 11, 2004, respectively. The Board issued an Order granting the intervention requests on August 31, 2004.

On August 20, 2004, the Department filed a motion to compel regarding a discovery request for cost of service information. On August 26, 2004, Verizon filed a motion to clarify the scope of the proceeding in response to the Department's discovery request. Following a September 1, 2004, oral argument, Discovery Officer George Young issued a decision on October 1, 2004, concluding that the cost of service information was potentially relevant to the issues to be considered by the Board in this proceeding and directing Verizon to respond to the Department's inquiries. On October 7, 2004, in response to Verizon's request for review, the Board issued an Order affirming the Discovery Officer's decision.

On September 8, October 7, and November 24, 2004, the Board issued scheduling orders that extended the anticipated date for a final Board decision until July 18, 2005[8] and extended the term of the Plan from April 22 to July 1, 2005. The Board also issued Protective Orders dated January 28, and April 22, 2005, providing for confidential treatment of information during the evidentiary hearings.

We held technical hearings on the direct testimony on January 31 through February 3, 2005, and hearings on the rebuttal testimony on April 26 through April 29, 2005. During the rebuttal hearings, the parties agreed that (1) the final Board order in this proceeding will be retroactive to July 1, 2005, and (2) that for calendar year 2005, Verizon's service quality will be

8. The anticipated date for a final Board order was later changed to September 19, 2005, due to additional scheduling revisions adopted during rebuttal hearings. The Board with the Company's agreement extended the term of the existing plan to this date.

governed by the less restrictive of either the service quality plan adopted in Docket No. 6167 or any successor retail service quality plan adopted by the Board.[9]

C. Statutory Framework

The present docket is governed by 30 V.S.A. § 226b, entitled "Incentive regulation of basic exchange telecommunications providers," which was enacted by the legislature in 1993 and amended in 1996. That section authorizes alternative forms of regulation and allows local exchange carriers (or the Board or Department) to propose alternatives to traditional rate of return regulation. For the reasons expressed above, and reiterated throughout this Order, alternative regulation has many attractive features in the emerging competitive environment; thus, the Board is conducting the present review of Verizon's Alternative Form of Regulation Plan, and the rates at the outset of the Plan, under Section 226b. In the alternative, the Board has the authority to examine Verizon's rates, in a traditional manner, by investigating those rates under Sections 225, 226, and 227.[10]

Subsection (c) of § 226b contains eleven criteria that an alternative regulation proposal must meet. The Board may approve such a proposal only if it finds, after notice and hearing, that such regulation, in its entirety:

> (1) promotes the general good of the state;
>
> (2) is consistent with State telecommunications purposes established under Section 202c of Title 30;
>
> (3) is consistent with the 10-Year State Telecommunications Plan, or there exists good cause to approve alternative forms of regulation notwithstanding this inconsistency;
>
> (4) is consistent with the public's interest relating to appropriate quality telecommunications services;
>
> (5) is consistent with the goal of protecting or promoting universal service to residential users of telecommunications;

9. This agreement to adopt the "less restrictive" of the two plans applies to each element of the plan.

10. No party argued that the Board should combine the present investigation under Section 226b with an investigation of Verizon's rates under Section 227(b), as we did in Dockets 5700/5702. Thus, the rate effects of today's Order are not retroactive.

> (6) provides reasonable incentives for the creation of a modern telecommunications infrastructure and the appropriate implementation of new cost-effective technologies;
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> (7) reasonably supports economic development in the affected service territory;
>
> (8) adequately protects consumer privacy interests;
>
> (9) supports reasonable competition;
>
> (10) includes adequate safeguards to insure that charges for non-competitive services do not subsidize competitive services; and
>
> (11) is just and reasonable and would not produce unjust discrimination between users of the public switched network in the pricing, quality or availability of the network functions or services offered.

30 V.S.A. §§ 226b(c)(1)-(11).

In addition to the eleven criteria, § 226b has a number of other provisions that deserve mention. Subsection (e) states that in reviewing a petition to approve an alternative regulation plan, the Board shall follow procedures substantially similar to those contained in 30 V.S.A. §§ 225, 226 and 227, and that the Board may prescribe the minimum contents of such a filing. This section also establishes a nine-month time frame for acting on the petition, which in the instant proceeding does not apply due to the fact that the Board, and not the Company, has opened the investigation.[11]

Subsection (f) empowers the Board to reject proposals for alternative regulation, or to issue an order of conditional approval, if it determines the proposal does not satisfy the requirements of § 226b.[12] If the Board issues an order of conditional approval, the parties may request further hearings on the modified plan; the Board must issue its final determination within 90 days of the original order. Any Board order approving or modifying an alternative regulation plan may not take effect sooner than 30 days from its issuance.[13]

An order establishing an alternative form of regulation may include the following: exemption from or reduction of the requirements of 30 V.S.A. §§ 218a, 225, 226 and 227; terms

11. 30 V.S.A. § 226b(e).
12. 30 V.S.A. § 226b(f).
13. 30 V.S.A. § 226b(g).

and conditions for establishing new services, withdrawing services, price changes to services, and contracted services; and other rates, terms, and conditions that the Board finds to be consistent with the general considerations and standards under this section.[14]

Subsection (i) allows the Board and Department to conduct investigations into the effectiveness of an approved alternative regulation plan already in effect. During the course of its predicted term, the statute also allows the Board, after notice and hearing, to terminate or modify an approved plan. 30 V.S.A. § 226b(i).

D. Positions of the Parties

Verizon has proposed what it calls its Alternative Form of Regulation plan for the Board's consideration in this proceeding. Verizon proposes to separate the Company's retail telecommunications markets into four general service categories: (1) Residential Basic Services; (2) Residential Non-Basic Services; (3) Retail Business Services; and (4) Other Services. Verizon assigns services to each category based on both the existing state of competition in the marketplace, as well as expectations of future marketplace changes.

The Residential Basic Services category includes basic residential exchange service and One-Party Non-optional measured service. Verizon's plan allows it to increase prices on these services by up to 10% annually during the term of the plan. Verizon proposes to insulate customers who qualify for Lifeline from these increases by implementing an offsetting increase in Lifeline support from the Company. The Residential Non-Basic Services category includes all other residential services and the Retail Business Service category includes all retail business service offerings. For these two categories, Verizon is proposing that it be allowed to raise rates as it chooses without limitation. For these first three categories, Verizon commits to meeting minimum price floor requirements but also proposes to eliminate notice and suspension provisions for tariff filings as set forth in 30 V.S.A. §§ 225–227. The Other Services category contains services that are either related to customer assistance programs or provided to other carriers. Verizon proposes no changes to the existing regulatory structure for these services.

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14. 30 V.S.A. § 226b(h).

With respect to retail service quality, Verizon proposes that the Board abolish the requirement from Docket 6167 that the Company operate under a retail service quality plan. In the alternative, Verizon proposes a plan that requires performance reporting to the Board by the Company, but eliminates any financial consequences to the Company for its failure to meet minimum service quality standards established by the service quality plan.

Verizon's proposed Alternative Form of Regulation is based on the assumption that there is sufficient competition in the telecommunications marketplace to restrain the Company from implementing unjust and unreasonable pricing for its services, and to insure that the Company provides adequate service quality to its customers, because those who are dissatisfied can easily switch to a competitive carrier.

The Department has proposed a successor plan that, with some exceptions, caps the prices for existing services but grants Verizon pricing flexibility, subject to price floor requirements, for all services considered new under the plan. New services under the DPS' proposal would include services introduced during the now-expiring Plan. Verizon would also be allowed to seek upward pricing flexibility for certain services or in certain markets should the Board determine that sufficient competition exists to restrain Verizon from implementing unjust or unreasonable pricing practices.

The Department also undertook a cost-of-service analysis in developing its proposal so that it could compare the benefits Verizon realized under the Plan to the benefits that the Company's Vermont customers experienced during the term of the existing plan. Based on this cost-of-service analysis, the Department determined that the Company was "overearning" in a traditional rate-of-return context by approximately $24 million. The Department also concluded that, while Verizon provided some new value to Vermont consumers over the life of the Incentive Regulation Plan, it did not do so in any material respect. Therefore, the DPS has proposed an incentive mechanism to insure that the Company creates appropriate value for Vermont customers in exchange for the benefits it has reaped, and without an appropriate incentive mechanism would continue to reap, under alternative regulation. In general terms, the Department's proposal presents the Company with a choice between potentially significant revenue reductions, or using some portion of the identified overearnings to invest in broadband capable facilities in as yet unserved areas or in certain qualifying network reliability improvements. The Department's proposal also includes both a retail service quality plan modeled after the plan approved in Docket 6167 with certain amendments, and a recommendation that the Board incorporate by reference Verizon's wholesale Performance Assurance Plan ("PAP") as it may be amended from time to time.

The Department disagrees with Verizon that the state of current and expected competition for telecommunications in Vermont rises to the level that should allow Verizon the flexibility that it seeks in its proposed Alternative Form of Regulation plan. The Department believes that it remains necessary to place some limits on the Company's pricing flexibility and to provide it with incentives designed to insure that Vermont ratepayers, and not only the Company, can realize the benefits associated with alternative regulation.

Lightship Telecom is a competitive local exchange carrier doing business in Verizon's service territory. It opposes the Verizon plan because of what it considers too-great pricing flexibility for Verizon, which it argues will allow Verizon to engage in predatory competition. Lightship Telecom supports the Department's plan.

II. Key Elements of Existing Plan and History

A. Verizon's Performance under Existing Plan

Findings

1. The Company's rate of capital additions and net investment balance declined over the term of the Incentive Regulation Plan. Lackey pf. at 24; Ostrander pf. at 4.

2. During the term of the Incentive Regulation Plan, Verizon did not reduce the price for any services other than as contemplated in the Board's Order approving the Incentive Regulation Plan. Lackey pf. at 26.

3. Verizon has introduced a few new service plans that offer consumers more favorable pricing terms than existing plans. Lackey pf. at 26.

4. The new services that Verizon introduced during the term of the Incentive Regulation Plan are nearly uniform with those introduced in other New England states, including New

Hampshire (in which Verizon does not operate under an alternative form of regulation). Lackey pf. at 27.

5. Verizon introduced several local calling packages. These packages offer consumers unlimited local and in-state toll calling for a flat rate. Lackey pf. at 30.

6. A significant proportion of residential consumers subscribed to these services. Lackey pf. at 30.

7. Verizon has also introduced several high-level data services over the course of the plan. Lackey pf. at 31.

8. Access to broadband services are important in Vermont, particularly in areas of the state that do not have high-speed, cable-based broadband service. Lackey pf. at 33.

9. Verizon Vermont lags behind Vermont's independent telephone companies and behind the average across the Verizon footprint in terms of DSL availability. Lackey pf. at 34.

10. Verizon's deployment of DSL services have been constrained by corporate-level capital allocation policies and practices, which delayed expansion of the service into many cost-effective areas. Verizon introduced DSL service to limited portions of Vermont during the Incentive Regulation Plan and only announced broader expansion during the course of this docket. Lackey pf. at 35; Docket 6533 Recommendation to FCC at 5.

11. Verizon's deployment of DSL has been targeted at locations with the greatest number of qualified loops at the lowest unit cost. Lackey pf. at 41.

12. The rate at which Verizon has deployed DSL has lagged demand. Many Vermont residents and businesses are frustrated that Verizon has not made broadband service available to them. Lackey pf. at 34, 42.

13. Verizon's service quality performance, as measured by the Service Quality Index, has deteriorated during the term of the plan, both in the number of performance ares that have not met baseline performance standards and the amount by which the Company has failed to meet the performance standard. Alexander pf. at 3.

14. The changing service quality has led to Verizon compensating ratepayers in the following amounts:

2000	$30,000
2001	$95,200
2002	$970,000
2003	$8,085,634
2004	$835,000

Alexander pf. at 3; exh. DPS-34 at 4.

15. The number of consumer complaints to the Department has also increased during the term of the Incentive Regulation Plan.

2000	.818 complaints per 1000 customers
2001	1.578 complaints per 1000 customers
2002	1.520 complaints per 1000 customers
2003	2.005 complaints per 1000 customers

Frankel pf. at 9.

16. Escalations have shown a similar trend to complaints. Frankel pf. at 9–11.

Discussion

As part of our assessment of the reasonableness of Verizon's proposed successor plan, Verizon's performance under the existing Incentive Regulation Plan, and the degree to which that performance matched our expectations, provides a useful benchmark. Five years ago, we adopted the now-expiring Incentive Regulation Plan for Verizon. Our approval was based upon our conclusion that the plan would benefit Vermont ratepayers. We observed that:

> Our approval of the Incentive Regulation Plan is based upon our expectation that moving from traditional rate of return regulation to incentive regulation should yield significant benefits to customers in Vermont, to Vermont local exchange carriers (such as Bell Atlantic) and to other carriers. Incentive regulation encourages a firm to operate more efficiently by setting general limits on unilateral price changes that a utility can make. It reduces regulatory constraints on companies and allows emerging competition to force utilities to adopt efficient and non-predatory practices. Incentive

> regulation is also designed to be flexible and to allow incumbent local exchange carriers such as Bell Atlantic to benefit its customers as it responds to markets and competes effectively.[15]

We also found that moving to incentive regulation:

> will encourage Bell Atlantic to deploy new technology, including that necessary to offer broadband services, and to move aggressively to introduce new services that will enhance its earnings. Our relaxation of regulatory requirements for new service introduction should further facilitate Bell Atlantic's movement in these directions.[16]

Verizon's performance against these expectations provides useful input into the effectiveness of the last five-year plan towards meeting the state's telecommunications needs and the conditions that may be necessary in future plans. The Department maintains that Verizon's performance over the term of the existing plan "does not support a conclusion that Verizon, on balance, has provided Vermont consumers with additional value in any material respect."[17] In fact, argues the Department, Verizon's service quality has declined, investment has remained flat or declining, few prices have decreased (except as required by the Board), and few existing tariffed services have been improved.[18]

Overall, the evidence supports the Department's analysis. In some areas, Verizon performance over the last five years has met the expectations the Board set out in the 2000 Order approving the Incentive Regulation Plan. In others, however, Verizon has either not taken advantage of the flexibility that the existing plan provided or has made corporate decisions such that Verizon's performance has not matched the expectations (which were based upon Verizon's representations). We briefly examine three key elements of the existing plan: marketing flexibility and pricing; service quality; and infrastructure deployment.

One of the major benefits of moving towards incentive regulation was to provide Verizon greater flexibility and incentive to deploy new products by relaxing review of tariffs and special contracts and by permitting Verizon to retain any increase in earnings that resulted. With these greater incentives, the parties and the Board expected that Verizon could and would expand

15. Dockets 6167/6189, Order of 3/24/00 at7 (footnote omitted).
16. Dockets 6167/6189, Order of 3/24/00 at 8 (footnote omitted).
17. Lackey pf. at 23.
18. Lackey pf. at 23.

service offerings in response to customer demand. The last five years has shown some positive results. Verizon introduced numerous bundled services that responded to customer demand and pressure from wireless providers; many of Verizon's customers now subscribe to these bundled plans.[19] Verizon has also introduced several high-speed data services.[20]

Beyond these new services, however, Verizon did little to take advantage of its marketing flexibility. Verizon did not reduce the prices for any of its services (except for price reductions mandated by the Board).[21] It is not unreasonable to expect that the bulk of Verizon's price reductions and new service offerings would be structured to directly respond to competitive alternatives, but the evidence suggests that no other price reductions occurred, even for services priced well above cost, such as basic toll services. Moreover, it does not appear that Verizon introduced any services in Vermont that were not introduced in other states, including states such as New Hampshire in which Verizon operates under traditional cost-of-service regulation.

The pricing and earnings flexilibity that we incorporated into the expiring Incentive Regulation Plan were also intended to create investment incentives. Here, Verizon's performance has been disappointing. In the area of advanced data services, however, Verizon's performance has been far below expectations. At the time we approved the existing Incentive Regulation Plan, we declined to adopt specific infrastructure requirements. Instead, we relied upon the express commitments of Verizon's Vermont President that the streamlined processes we adopted and the pricing flexibility would drive technology and that Verizon would deploy its capital and new technology based upon forecasts of customer demand.[22] We concluded that:

> in the case of the infrastructure necessary to provide high speed connectivity, the Company asserts that the market now exists and will prompt deployment

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19. Lackey pf. at 28– 30.

20. Lackey pf. at 31.

21. Lackey pf. at 26.

22. Dockets 6167/6189, Order of 3/24/00 at 134. Verizon has stated in the current proceeding that the regulatory climate has a large effect on its investment and product deployment decisions. Exh. Board-1; tr. 1/31/05 at 86–87 (Porell). However, Verizon has acknowledged that the regulatory climate is a much less significant factor than customer demand. Tr. 1/31/05 at 86–88 (Porell). Considering that Verizon operated under the regulatory climate that it sought *and* that customer demand for broadband services existed, Verizon's decisions not to rapidly deploy DSL services and the slow and limited subsequent deployment are surprising and call into question some of the assumptions of the benefits of incentive regulation.

> of Digital Subscriber Line technology to meet that demand. We expect that Bell Atlantic will move rapidly to fulfill this commitment.[23]

Verizon's performance has not matched these expectations. DSL deployment in Vermont has been slow both in terms of the number of central offices equipped to provide DSL services and in making the service available to all customers once the central office is equipped.[24] This has resulted not from an absence of customer demand (which Verizon had asserted would be the basis for deployment decisions), but rather due to a corporate policy to defer deployment.[25] We previously expressed our concern about this policy:

> Strong demand for DSL services exists within the state of Vermont, as evidenced by the relatively high penetration of DSL services in areas of Vermont served by other Vermont incumbent local exchange carriers and enrollment for broadband internet services from cable broadband providers in the limited parts of Vermont served by cable providers.
>
> Some Verizon customers do receive DSL service from Verizon, but service is available only to customers located in certain wire centers. Verizon's marketing has also been quite limited. In this context, the Board has been disappointed with Verizon, and understands that the situation is largely the result of conscious choice by Verizon. At this time, Verizon has elected not to expand its DSL services offerings here, despite evidence of significant demand for such. [26]

Just prior to the hearings in this case, Verizon expanded its broadband deployment, announcing the extension of service to another group of central offices at the outset of hearings in this case. But the extensive delays meant that customers could only obtain broadband services from Adelphia Cable Communications, which has aggressively upgraded its network to provide such services. Nevertheless, many customers remain without service either because Verizon's central

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23. Dockets 6167/6189, Order of 3/24/00 at 134 (footnote omitted).

24. Many customers in central offices that have DSL service still cannot get it, because Verizon has not deployed the necessary equipment to extend the service. The independent telephone companies have generally overcome these barriers. *See* generally tr. 2/3/05 at 92–93 (Gabel).

25. Customer demand in rural areas is high as evidenced by the high penetration rates (over 24 percent) achieved by Vermont Telephone Company. Gabel pf. at 27–28.

26. Docket 6533, Recommendation of 2/6/02 at 5 (footnotes omitted).

office is not yet equipped or because Verizon has not yet deployed the facilities necessary to serve customers beyond 18,000 feet.[27]

In the area of service quality, Verizon began the five-year plan by essentially meeting the standards that it and the Department had agreed would reasonably measure service quality and that these parties recommended the Board accept. For example, in 2000 and 2001, Verizon met nearly all of the service quality standards and, for those standards that it failed to meet, Verizon did not greatly exceed the standards. This performance is reflected by the small compensation payments ($30,000 and $95,200, respectively) in those two years. By comparison, over the last three years of the Service Quality Plan, Verizon paid significant amounts of compensation, reflecting poorer performance than at the outset of the plan.

Incentive regulation did not prevent a slide in service quality. However, the existence of the Service Quality Plan provided a direct consumer benefit that would not have existed otherwise — compensation when service quality did not meet the applicable standards. The Board's existing service quality plans, established in Docket 5903, do not have any consequences attached when a company fails to meet them. Unlike the gas and electric utilities, all of which have developed service quality plans with binding standards and consumer compensation, telephone utility standards do not require any compensation. The Service Quality Plan incorporated into the existing Incentive Regulation Plan thus provided consumers with direct compensation that would not have existed otherwise.[28]

As the discussion in the next section describes, it also does not appear that consumers benefitted by the fact that Verizon absorbed the risk of underearning. To the contrary, Verizon appears to have attained earnings in excess of what the Company would have been entitled to if it had operated under rate-of-return regulation.

Alternative regulation did, however, create incentives for Verizon to reduce its costs to maximize earnings. During the term of the plan, the Company continued workforce reduction efforts that will, over the long term, lead to decreased costs. Doubtless, some of the overearnings

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27. By comparison, the independent telephone companies in Vermont have extended service to nearly all of their customers.

28. Obviously, it would have been preferable had Verizon simply met the service quality standards.

we now find are attributable to cost-cutting efforts that may arise (at least in part) from the incentives that the alternative regulation plan created.[29]

Overall, the record supports the conclusion that the Incentive Regulation Plan created appropriate incentives that led to some benefits for consumers. These incentives, however, did not appear to be sufficient to persuade Verizon to deploy DSL services or maintain high service quality, notwithstanding the Company's representations at the time it asked us to adopt the Plan. Moreover, Verizon has been unable to identify specific investments or expenditures that Verizon undertook as a result of the relaxed regulatory policies.[30] The successes and shortcomings of the existing plan directly affect our consideration of Verizon's successor plan.

III. CONSEQUENCES OF ENDING ALTERNATIVE REGULATION

A. Introduction

This proceeding constitutes the Board's review under Section 226b of Verizon's proposal for a successor to the Incentive Regulation Plan that is now expiring. Incentive regulation is not, however, presumed under state law.[31] Instead, it is an option that the Board must consider and can adopt only if we find that it meets the criteria delineated in the statute. The first of these criteria requires that we find that the incentive regulation plan promotes the general good of the state. Implicitly, this requires a finding that adoption (or continuation) of an alternative form of regulation will provide at least the same level of benefits as traditional regulation. We enunciated this concept in a procedural order earlier in this docket: the overarching goal of the

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29. The increase in service quality payments may also be a reflection of personnel reductions. If the workforce reductions were, in fact, partially or wholly responsible for reduced service quality, we do not consider such cost cutting efforts beneficial.

30. Lackey pf. at 24.

31. Verizon has taken advantage of the fact that incentive regulation is optional. For example, in 1994, the Board adopted an incentive regulation plan for NYNEX (Verizon's predecessor). Dockets 5700/5702, Order of 10/5/94. Verizon, exercising an option available to it under the version of Section 226b that existed at that time, elected to decline to be regulated under the plan ordered by the Board. Dockets 5700/5702, Order of 3/13/95. Later, in Docket 6000, Verizon elected to withdraw an incentive regulation proposal before hearings after the Board concluded that independent review was necessary. Docket 6000, Order of 4/2/98. Verizon acknowledged the option of reverting to rate-of-return investigation again prior to the Board's initiation of this proceeding, when the Company stated that it was considering not pursuing a successor incentive regulation plan. Letter of 4/26/04 from Pamela J. Porell to Judith C. Whitney.

statutory criteria in Section 226b is consumer benefit. We observed that "incentive regulation is intended to produce higher earnings only as an incentive to produce increased value for consumers." This standard is equally applicable in the context of a renewal plan as it is to the initial incentive regulation plan. If consumers are not receiving sufficient value from the plan, adjustments may be appropriate.[32]

To this end, we now consider the likely results of reverting to traditional regulation, so as to provide a benchmark for assessing the merits of Verizon's proposal and the changes necessary to assure sufficient benefits to consumers. This entails an examination of Verizon's earnings as well as the other major elements of incentive regulation plans that may be lost if we do not approve such a plan — mandatory service quality standards and Verizon's use of the incentives set out in the plan to deploy new services and infrastructure and reduce prices.

One major question raised by the parties is the examination of Verizon's rates. Verizon maintains that such a review is not required by the relevant statutory criteria.[33] Verizon argues that conducting a cost of service review would "undermine the improved incentives created by the Board's adoption of alternative regulation by recreating the linkage between prices and reported costs."[34] Verizon also maintains that regulated companies will not internalize the improved incentives of alternative regulation if they believe that the productivity benefits will be extracted on a regular basis.[35] Moreover, according to Verizon, a cost-of-service-based adjustment would constitute a "fundamental policy change" that would conflict with Verizon's expectation.

On a practical level, Verizon asserts that a cost-of-service review would not be useful because it only examines overall costs rather than the costs of particular services (which should be based upon total service, long-run incremental costs ("TSLRIC"). Finally, Verizon contends

32. Order of 10/7/04 at 3–4 (footnotes omitted).

33. Verizon Brief at 12–13.

34. Vasington reb. pf. at 6; Verizon Brief at 6.

35. Vasington reb. pf. at 10.

that an analysis of its earnings during the 2000 Plan (as opposed to a cost-of-service review) shows that no rate adjustment is warranted.[36]

The Department addressed many of Verizon's arguments during challenges to the scope of this proceeding.[37] The Department disputes Verizon's assertions that the Company's earnings over the term of the Plan show that the Company underearned, so that no rate adjustment is appropriate. In addition, the Department (noting that Verizon bears the burden of proof), argues that Verizon should have presented information on the cost of particular services if it found that the Board should have considered such analyses.

In large part, we addressed Verizon's arguments concerning cost-of-service review earlier in this proceeding and we do not need to reiterate our conclusions in the October 7, 2004, Order and the Discovery Officer's October 1, 2004, Order that we upheld. In those Orders, we concluded, as we do now, that an examination of cost-of-service issues in this proceeding is necessary for three primary reasons.

First, we find such review to be a necessary part of finding that the alternative regulation plan promotes the general good under Section 226b(c)(1). We have previously ruled that "this criteria encompasses a finding that the rates at the outset of the plan are set at reasonable levels so that the earnings Verizon derives under the plan stem from its decisions rather than from artificially high rates."[38] We also commented that alternative regulation:

> is not intended to simply reward a company with higher earnings, but rather to allow the company an opportunity to obtain such earnings through positive actions. Thus, just and reasonable starting rates are inherent in an incentive regulation plan; otherwise a company commencing with earnings above or below just and reasonable rate levels would unfairly benefit or be harmed throughout the term of the plan, without taking the risk that incentive regulation presumes.[39]

36. Verizon Brief at 9. Verizon's view is that the appropriate analysis framework is its earnings statements rather than a cost-based review.

37. See Orders of 10/1/04 and 10/7/04.

38. Order of 10/7/04 at 3; Dockets 6167/6189, Order of 3/24/00 at 96.

39. Dockets 6167/6189, Order of 3/24/00 at 103.

These same principles, which arise from the "public good" mandate, applies equally at renewal. Renewing a plan based upon excessive rate levels may benefit Verizon, but it is not clear how such a result promotes the public good.

Second, as we discussed above, Vermont law does not mandate alternative regulation. Rather, it is an option. But any meaningful analysis of the merits of an incentive regulation plan must consider the opportunity cost — if the Board elected not to continue incentive regulation, would rates and customer value be higher or lower. Over time, assuming Verizon passes through its efficiency gains in the form of rate reductions, new services, or higher service quality, one would expect that customer value would be greater under incentive regulation. Certainly, the Board's 2000 decision adopting the Incentive Regulation Plan was founded upon that premise. This Proposed Order reaches the same conclusion, with conditions included that are appropriate to ensure that alternative regulation will provide greater benefits than would the alternative.

Third, when assessing Verizon's performance over the term of the existing plan, it is apparent that the Board's expectations concerning infrastructure deployment — particularly of broadband services to all of Verizon's customers — have not been met. Slow deployment of broadband services may have been reasonable if competition had significantly eroded Verizon's financial ability to meet customer demand (which the evidence shows did not occur).

We recognize that the possibility that Verizon may need to periodically reduce rates may reduce the incentives inherent that alternative regulation is intended to obtain. Any such reduction is likely to be small, particularly as Verizon is able to retain all of the benefits of its decision in the interim. Moreover, incentive regulation is intended to benefit both Verizon and ratepayers. If Verizon simply retains earnings without increasing customer value, it is not clear how consumers (as opposed to Verizon) have benefitted.[40]

As we did in our procedural rulings, we decline to rely upon the experience in other states cited by Verizon. Our decision is founded upon Vermont law and sound policy decisions. Moreover, we note that one of the primary decisions in other states that Verizon asks us to rely

40. This is particularly true for a declining-cost industry such as telecommunications. Over time, consumers should expect rate decreases or enhanced services.

upon has been reversed by the Supreme Judicial Court of Maine. In that case, the Court required an analysis of the rate levels that would exist in the absence of alternative regulation.[41]

We also find Verizon's arguments concerning the costs of individual services and reliance upon its earning statements to be unpersuasive. If Verizon believed that the Board needed to examine the costs of particular services, it could have presented that data (although the Board already has a forward-looking cost assessment for Verizon in the form of the Statement of Generally Available Terms). Having chosen not to produce evidence upon the costs of individual services, Verizon is ill-placed to argue that such an examination was necessary.

Verizon's earnings statements are, of course, relevant to this proceeding. But, the evidence (as shown in the cost-of-service analyses) demonstrates that they do not accurately reflect the underlying costs. Thus, they carry little weight.[42]

<u>B. Rate Effects of Existing Alternative Regulation Plan</u>

<u>1. Contested Cost of Service and Rate Base Issues</u>

On those issues where the parties could not resolve their differences of opinion, we make the following findings of fact.

<u>Test Year</u>

<u>Findings</u>

17. The twelve-month period ending December 31, 2003, is an appropriate test year period for the purpose of assessing a reasonable range of revenues for Verizon. Ostrander pf. at 7.

<u>Discussion</u>

In a cost of service investigation, the customary approach to establishing a utility's revenue requirement is to select a test year that is reasonably expected to represent the future operations of the utility. There is no particular requirement that a test year must be based on the

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41. *Office of Public Advocate v. Public Utilities Com'n*, 866 A.2d 851 (Me. 2005).

42. If Verizon's earnings statements fully reflected the cost-of-service methodologies employed by the Board, as we stated in Dockets 6167/6189 they should, they may provide more useful information.

calendar year. Once a test year has been established, known and measurable changes are added to or taken away from test year revenues and expenses. The adjusted test year results are then used to establish the Company's required revenues.

The Department proposes a 12-month test year ending on December 31, 2003. In the Department's view, this 12-month period is reasonable, recent and avoids the problems associated with mid-year cut-offs. The Department also claims that Verizon's proposal (included in its rebuttal testimony) to change the test year a full nine months after the start of this investigation would be unduly prejudicial and fundamentally unfair.

Verizon recommends using a 12-month test year ending on June 30, 2004. According to Verizon, the telecommunications marketplace is in a state of flux. Therefore, the Company argues, the Board should use the most recent data that is available as this is more reflective of the future operations of the Company. Verizon refutes the Department's claims that the Company proposed a new test year at the "last minute" during this proceeding and that the Company's proposal to change the test year was fundamentally unfair. The Company states that in the absence of a Board order or an agreement establishing a test year, each party is free to use any test year it wants. Lastly, Verizon contends that the Department waived any legal challenge to a June 30, 2004, test year by failing to object in a timely manner.

The Board has not previously established requirements for selection of a test year. Typically, a company filing a rate increase will select a recent 12-month period for which reliable data exists, so long as that period is a useful predictor of the Company's future operations.[43] In the context of an investigation into existing rates, we would ordinarily set the test year at the prehearing conference. Here, no party proposed a particular test year early on in the proceeding, including Verizon. In fact, Verizon opposed any examination of its rates, including any discovery by the Department into costs and revenues.[44] The first time any party proposed a test year occurred when the Department included its review of Verizon's cost-of-service in its testimony.

43. *Letourneau v. Citizens*, 128 Vt. 129, 133–134 (1969).

44. We ordered Verizon to respond to this discovery on October 1 and October 7.

Even at that time, Verizon did not object to the Department's time period. It was not until Verizon filed its rebuttal testimony much later that Verizon, for the first time, proposed using a different test period.[45] We agree with the Department changing the evaluation period so late in the proceeding, especially from the party that bears the burden of proof and has access to the financial information, is simply unfair.[46]

Verizon has also not shown that selection of the calendar-year 2003 is flawed. We recognize that the telecommunications marketplace is evolving and that, in general, more recent data is preferred. However, we cannot conclude that recent events are so tumultuous that an additional six months of operating data would materially affect the usefulness of the Department's test year. Moreover, contrary to Verizon's claims that recent events have deteriorated earnings, the record evidence indicates that for the 12-month period ending December 31, 2004, Verizon's earnings actually improved by approximately $10 million.[47] As such, based on the record evidence, we conclude that the 12-month period ending December 31, 2003, is an appropriate test year for the purpose of establishing base revenue levels in this proceeding. The December 2003 test year is recent information that reasonably reflects the future operations of the Company.

Annual Depreciation Expense (Adjustment No. 1)

Findings

18. The purpose of depreciation is to allocate the cost of assets over their expected life. Depreciation includes the cost of acquiring the asset, plus the estimated future net salvage value. Lacey reb. pf. at 5.

19. Future Net Salvage value is defined as the estimated gross salvage value of an asset, less the estimated future cost of removal. When the estimated future net salvage value of an asset is positive, an asset is fully depreciated. Conversely, when the future net salvage value of an asset

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45. Ostrander surr. pf. at 5–6, 8–9.

46. Moreover, we are mindful that, during the hearing on the Department's motion to compel, Verizon asked the Department to limit its inquiry to a single year, rather than providing data over longer periods — a request to which the Department largely agreed. It is at best inappropriate for Verizon to ask for more limited discovery and then propose a different test period.

47. Tr. 4/28/05 at 169 (Ostrander).

is negative, the cost of removing the asset exceeds the estimated salvage value of the asset. In these instances, the depreciation reserve balance exceeds the asset's gross salvage value and the asset is not fully depreciated until the cost of removal has also been recovered. O'Quinn reb. pf. at 13.

20. Including the estimated future net salvage value in depreciation rates is an appropriate methodology for determining the amount of annual depreciation expense for plant in service and for calculating depreciation reserve accounts. O'Quinn reb. pf. at 13.

21. Verizon reported depreciation expenses of $15,485,212 in the Aerial Cable - Metallic ("ACM") plant account in the 12-month period ending December 31, 2003. Exh. DPS-BCO-13.

22. In determining the amount of regulatory depreciation expenses for the Aerial Cable - Metallic account, Verizon applies a depreciation rate of 9.1%, which implies an estimated service life of 11 years. Exh. DPS-BCO-13.

23. In determining the amount of depreciation expense for reporting purposes other than regulatory reasons, Verizon applies a depreciation rate of 4.2% to Aerial Cable - Metallic account. This implies an estimated service of 24 years for Aerial Cable -Metallic plant. Ostrander surr. pf. at 20.

24. Although the Aerial Cable - Metallic plant account has recently become fully depreciated, expected future investments in Aerial Cable - Metallic plant indicates that the Company will have a continuing depreciation expenses of $8,200,000. Ostrander surr. at 20–22; exh. DPS-BCO-13.

25. Verizon reported regulatory depreciation expenses of $1,764,056 for the Buried Cable-Metallic ("BCM") account in the 12-month period ending December 31, 2003. Exh. DPS-BCO 13.

26. The Buried Cable - Metallic plant account is expected to become fully depreciated by December 31, 2005. Ostrander surr. pf. at 21–22; exh. DPS-BCO-14.

27. Verizon reported regulatory depreciation expense of $2,964,873 in the Underground cable - Metallic ("UCM") account in the 12-month period ending December 31, 2003. Exhs. DPS-BCO-13 and BCO-14.

28. Because the Underground Cable - Metallic plant is substantially depreciated, Verizon stopped accruing depreciation expenses sometime in 2003. Ostrander surr. pf. at 22; O'Quinn reb. pf. at 12a (revised); tr. 4/26/05 at 183-185 (O'Quinn).

29. The un-depreciated value of Verizon's rate base has declined in recent years as more telecommunication plant is being "used up" faster than the rate of new investment. Ostrander pf. at 19.

Discussion

Depreciation represents an annual charge to income that results from the systematic and rational allocation of the cost of an asset over its expected life.[48] The charge enables a utility to recover the capital it prudently invests in telecommunications plant for the provision of customer services, including the estimated cost of removing the asset after its useful life. Annual depreciation charges are established pursuant to periodic depreciation studies which validate the expected service lives of plant in service, their estimated salvage values and removal costs. A depreciation study was last completed by Verizon sometime before 1995.

In this proceeding, Verizon and the Department disagree over the amount of depreciation expense to be included in rates over the term of the successor plan.[49] The Department recommends reducing depreciation expense by $13.323 million. The Company argues that there is no basis for reducing or terminating depreciation expenses.[50]

According to the Department, there are four primary reasons for reducing or eliminating depreciation expenses in the Aerial Cable - Metallic, Buried Cable - Metallic and Underground Cable - Metallic accounts. First, the Company's depreciation rates contain excessive removal costs. Second, Verizon's regulatory depreciation rates for many plant accounts are high in

48. *See* 2003 Interpretations and Applications of Generally Accepted Accounting Principles, Delany, P., et. al., pg. 325.

49. Lightship did not provide comments on this issue.

50. Verizon Reply Brief at 12.

comparison to the Company's financial and interstate books.[51] Third, investment in intrastate plant has declined over recent years; meaning that Verizon's telecommunication plant is being depreciated at a faster rate than the rate of new investment. Finally, the Department maintains that these three accounts are either fully depreciated or will become so during the term of the Plan.

Verizon claims that the Department's recommendation is inappropriate because the revised adjustments contain numerous errors. Verizon also asserts that the Department's analysis was biased. According to Verizon, the Department selectively chose depreciation rates for plant accounts that supported the Department's position but ignored the depreciation rates of other plant accounts when such rates would have produced higher expenses. Verizon also criticizes the Department's analysis because it focused primarily on Future Net Salvage values, which represent a portion of the total depreciation. In Verizon's opinion, the Department's analysis does not take into account other depreciation parameters such as actual removal costs and accumulated depreciation. Lastly, Verizon states that the Board approved the current depreciation rates with the understanding that the rates were higher than the Company's financial and interstate depreciation rates.[52]

Future Net Salvage

The Parties' disagreement over depreciation is largely due to differing opinions on the cost to remove assets in the Company's Aerial Cable - Metallic, Buried Cable - Metallic and Underground Cable - Metallic accounts. If the cost of removing plant is high, then the rate used to determine depreciation is relatively higher in order to collect from current customers the funds needed to remove the asset at the end of its useful life. Conversely, if the cost of removal is low, then the depreciation rate is lower. In this proceeding, Verizon contends that the removal costs of the above-mentioned asset categories are greater than the costs estimated by the Department.

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51. We note here that it is customary for utilities, like Verizon, to maintain up to four sets of accounting records. These include accounts for tax reporting, financial reports to the Securities and Exchange Commission, interstate reports to the FCC and intrastate reports to the Board. In this proceeding, we are primarily concerned with Verizon's intrastate accounts as they are used for determining the Company's required revenues.

52. Verizon Reply Brief at 14.

Because Verizon contends that removal costs are higher in relation to the Department's estimates, the Company expects to incur future removal costs in excess of the funds that have been accrued to date under current regulatory depreciation rates. In contrast to Verizon's opinion, the Department asserts that the Company has already collected sufficient funds to remove these assets, if necessary. This is so, according to the Department, because the regulatory depreciation rates used to calculate annual depreciation expenses are excessive, especially in comparison to the depreciation rates the Company uses for financially accounting purposes. As a result of the Company's excessive depreciation, the Department recommends eliminating depreciation expenses for the Buried Cable - Metallic and Underground Cable - Metallic accounts. In addition, the Department asks the Board to order Verizon to issue a customer credit of $1.3 million annually over a five-year period as a result of over-collecting depreciation in the Underground Cable - Metallic account. For the Aerial Cable - Metallic account, the Department recommends reducing depreciation to $8.2 million, even though the account is fully depreciated because there is a continuing need to invest in aerial plant.

Customers who benefit from Verizon's services are obligated to pay for the full cost of the assets used in the provision of their services, including an appropriate cost for the future removal of assets. In this sense, a portion of the depreciation charge – future net salvage – is prepaid by customers. The record evidence, however, leads us to conclude that the Buried Cable - Metallic and Underground Cable - Metallic accounts have been fully depreciated. Sufficient funds have been collected to pay for the estimated cost of removal irrespective of the assumptions used to estimate future net salvage values. As such, regulatory precepts require us to accept the Department's recommendation and to eliminate depreciation charges associated with Buried Cable - Metallic and Underground Cable - Metallic assets from Verizon's cost of service.

With regard to Aerial Cable - Metallic plant, the Department has shown that the 9.1% depreciation rate used by Verizon for regulatory purposes is overly aggressive. The Company currently collects from customers $15.485 million annually in depreciation. Had the Company applied the depreciation rate that it uses for financial reporting purposes in place of the depreciation rate used for regulatory reporting, the Company's annual depreciation expense for aerial cable - metallic assets would have been reduced to roughly $8.2 million. The record evidence also indicates that irrespective of the removal cost estimates, the account will be fully depreciated within a few years. Based on the record evidence, we find that the Company's assertions regarding the propriety of a higher regulatory depreciation charge for its Aerial Cable - Metallic assets are inconsistent with the depreciation charges that the Company records on its financial reports. Under higher regulatory rates, the Company has been collecting more money from ratepayers than is appropriate. Additionally, it is apparent that sufficient funds have been collected to remove these assets in the future. Therefore, we conclude that an expense reduction of $7.285 million is warranted.

We acknowledge Verizon's assertions that it stopped accruing depreciation expenses on the Underground Cable - Metallic account in 2003 and that the Department's cost of service adjustment double-counts the amount of depreciation for this account. However, the record evidence does not inform us as to when the Company stopped accruing depreciation. If the Company stopped accruing depreciation expenses at the beginning of 2003, then it would be appropriate to remove a substantial portion of the Department's proposed adjustment as the adjustment would have the effect of double counting the Department's recommended reduction. Conversely, if the accruals stopped at the end of 2003, then most of the Department's downward adjustment to Verizon's cost of service would be necessary. Before ruling, we will allow the Company and the Department to submit additional comments on when the Company actually ceased accruing depreciation on this account.

Finally, we conclude that it would be inappropriate to approve of the $1.3 million Underground Cable - Metallic credit to customers as the Department recommends. These funds have been collected from current customers and have been accumulating in a reserve account to pay for the future removal of Underground Cable - Metallic plant. Under current regulatory policy, we have previously concluded that it is appropriate for current customers who enjoy the benefits of the assets used in the provision of their services to pay for the full cost of those assets, including the cost of removal. The Department's recommendation, however, has the potential to create inequities between current and future customers by requiring future customers to pay for the removal of Underground Cable - Metallic assets that they did not use. Additionally, under the incentive regulation plan, these funds arguably belong to the Company as rates during the term of the plan and were not subject to additional reductions. To rule now that Verizon had been overcharging customers as a result of differing opinions over the appropriate depreciation rate in this proceeding would be viewed as retroactive rate-making. Therefore, we reject the Department's recommendation to order Verizon to issue an annual $1.3 million credit to customers.

Selective Plant Adjustments

In Verizon's opinion, the Department selectively used those depreciation rates that included Future Net Salvage values which supported the Department's position but ignored depreciation rates that included Future Net Salvage values that may have produced higher expenses.[53] As an example of the Department's selectivity, Verizon points out that the Future Net Salvage value for poles under financial reporting is negative 110%, but under regulatory accounting practices, Verizon's poles are reported as having a negative 68% Future Net Salvage value. Had the Department made a recommendation based on financial reporting values, the Department adjustment would have been modified, and presumably lowered.

We conclude that the Department conducted a comprehensive review of Verizon's major plant accounts. While conducting its review, the Department discovered that telecommunication plant for all types of assets were declining at a rapid rate.[54] The Department also discovered that several plant accounts, in addition to those captioned above, were fully depreciated.[55] Furthermore, the record evidence indicates that Verizon records depreciation charges of approximately $56 million annually, representing a current average depreciation rate of 8.0 percent of total plant in service. The rate of new investment in Vermont, however, amounted to approximately $34.1 million in 2003; or about 4% of gross plant in service.[56] Because the rate of new plant investments has not kept pace with the rate of depreciation, roughly 80% of the Company's intrastate plant in service has become fully depreciated. Thus, we find Verizon's

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53. Verizon Reply Brief at 14.

54. Ostrander pf. at 19.

55. Plant accounts that were fully depreciated included Office Support Equipment, Radio Systems (which was fully depreciated in 1993, Analog Circuit Equipment and Furniture. Ostander pf. at 23.

56. Ostrander pf. at 15–16.

criticisms of the Department's analysis to be unpersuasive. The evidence clearly indicates that depreciation rates are excessive and under these aggressive rates, Verizon has been able to collect sufficient funds to remove the assets, including poles, at the end of their useful lives.

Other Depreciation factors

Verizon contends that the Department's analysis ignores other factors such as the historical cost of removing Aerial Cable - Metallic assets, the impact of the Department's SFAS 143 adjustment and, finally, the effect of the timing of new plant additions placed into service. Therefore, the Company states that the Department's recommendation should be rejected.

According to Verizon, the Department's cost estimate for Aerial Cable - Metallic removal is less than the actual costs Verizon reportedly incurred during the 2000-2004 time period. Instead,Verizon asserts that the actual cost of removing Aerial Cable - Metallic assets ranged from negative 44 percent of the original cost to negative 170 percent. Therefore, the Aerial Cable - Metallic account has not been fully depreciated, according to Verizon, and additional funds are necessary.

The Department claims that Verizon's estimates for future removal costs, which are expressed as a negative 36 percent of the gross value of the underlying asset, are based on a depreciation study that has not been reviewed since sometime before 1995.[57] According to the Department, Verizon's current depreciation rates over-collect the amount necessary to remove these assets. Additionally, the Department states that irrespective of the Future Net Salvage rate, the amount of depreciation reserve held in the Aerial Cable - Metallic account is approximately $6 to $7 million short of being fully depreciated. If current depreciation expenses of $15 million remain in effect over the term of the successor plan, the Aerial Cable - Metallic account will become fully depreciated within six months.

We find that Verizon's arguments that actual removal costs during the five-year period ending in 2004 exceeded the estimated costs to be unpersuasive. As we stated above, Verizon's overall depreciation expenses are aggressive. As a result, the amount of funds already accrued

57. Department Brief at 18.

for depreciation reserves on the Company's intrastate accounts are sufficient to pay for the cost of removing Aerial Cable - Metallic assets.

Verizon claims that the Department's recommendation to reduce depreciation rates as a result of the Company's adoption of SFAS 143 is also inappropriate. As will be discussed in greater detail in the next section, SFAS143 requires Companies to record the cost of removal only when the asset is actually removed. Therefore, under current financial reporting practices, depreciation rates exclude Future Net Salvage values from depreciation charges. Were the Board to adopt the Department's recommendation, Verizon claims that it will not be able to collect the necessary funds to remove assets before they are actually removed. Also, by excluding Future Net Salvage values from depreciation, the Department's recommendation, according to Verizon, would create inter-generational inequity by requiring future customers to pay for the cost of removal.

The Department argues that Verizon's adoption of SFAS 143 initially had a positive impact on the Company's operations and that future impacts, if any, as a result of omitting Future Net Salvage values from current depreciation rates would not be measurable.[58] The Department states that due to Verizon's aggressive depreciation rates and declining rate of new investment, the Company has collected ample depreciation reserves to pay for removal of assets from current customers.

Based on the record evidence, we conclude that Verizon has collected sufficient funds to remove assets in the Aerial Cable - Metallic, Buried Cable - Metallic and Underground Cable - Metallic accounts irrespective of Verizon's adoption of SFAS 143 for financial reporting purposes. By applying the Company's regulatory depreciation rates, the Company has been able to accrue $57 million more in its depreciation reserves than the amount of depreciation currently booked as reserves for financial reporting purposes. Moreover, the record evidence indicates that the Company has no immediate need to remove these assets all at once in the near future. Thus,

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58. Department Brief at 31(Confidential) and 33. The Department argues that any increase in removal costs, if any, would be offset by decreases in depreciation expense. As a result, the effect of any prospective changes in expectations would cancel each other out and Verizon would be indifferent.

we find that Verizon's assertions regarding the potential impact of SFAS #143 to be unpersuasive.

Finally, Verizon contends that the Department adjustment to Aerial Cable - Metallic depreciation is unfair because it assumes that $7.8 million in proposed plant additions are placed in service at the beginning of the year. The effect of this proposal would be to overstate contributions to accumulated depreciation at the end of the year and reduce rate base upon which the Company earns a return. According to the Company, plant additions and accumulated depreciation should be "rateably" recorded on the Company's regulated intrastate accounts over the course of a full year.[59]

Verizon's assertion that the effect of the Department's proposed adjustment will overstate year-end accumulated depreciation reserves is correct. However, there is more to consider than just the rate base effects of the Department's proposed adjustment. If the Board were to consider the effect of averaging plant additions and contributions to accumulated depreciation over the course of a year, as the Company proposes, the Board would also have to consider the timing of when depreciation (on the new plant additions) is recorded on the Company's accounts and the effect of such timing on the cost of service. Such changes to depreciation would have the effect of lowering expenses over the course of the year and have a greater impact on the Company's revenues than would the effect of averaging only the contributions to accumulated depreciation. Thus, we conclude that the Department's recommendation to increase the Aerial Cable - Metallic plant account by $7.8 million annually as if the additions were placed in service at the beginning of each year is a reasonable approach for the purpose of determining an approximate revenue level for the successor plan.

Docket 5700/5702 Depreciation Rates

Verizon asserts that the Department supported, and the Board approved of, the depreciation rates currently in effect in Dockets 5700/5702. As a result, there is no basis for reducing depreciation as proposed by the Department in this proceeding. Specifically, Verizon claims that the Board approved of an aggregate 8.7 percent intrastate depreciation rate even

59. Verizon Proposed Findings of Fact at 18.

though the aggregate interstate rate was 8.0 percent based on a stipulation between the Company and the Department.

The Department did not specifically comment on the Board's past ruling regarding depreciation rates.

While past Board decisions inform our decisions in instant proceedings such as this one, neither the Board nor the Department are bound to these past decisions. Facts and circumstances change with the passage of time and so should Board decisions if the circumstance warrants such a change. As we have stated in other proceedings, our decisions are based on the record evidence. In this proceeding, we conclude that the record evidence demonstrates that the current depreciation rates are aggressive for the reasons stated above and that Verizon is recovering its invested capital in plant assets at a rapid pace.

We also note that the Board's decision in Dockets 5700\5702 to adopt a higher intrastate depreciation rate than the rate Verizon used for interstate purposes was based on the premise that Verizon would rapidly modernize its Vermont telecommunication network.[60] In Dockets 5700\5702, Verizon argued that higher depreciation rates were necessary in order to effectively respond to growing competitive threats. With higher depreciation rates, the Company argued that it would be able to recover invested capital at a faster rate and then reinvest the funds into new telecommunications plant in response to new competitors entering the Vermont marketplace.

The record evidence indicates that the Company overstated its previous assertions that higher depreciation rates were necessary in order to effectively respond to competitive threats by rapidly reinvesting depreciation funds back into the telecommunications network. In contrast to Verizon's previous assertions, the record evidence, as we mention above, indicates that the rate of investment in new plant has not kept pace with the rate of depreciation. Furthermore, the telecommunications network has not been upgraded as rapidly as the Company stated it would do so in 2000. Additionally, the degree of competitiveness in Vermont's telecommunications market is not as intense as Verizon originally envisioned in 2000. In recent years, a host of Competitive Local Exchange Carriers have exited the Vermont market or stated that they would

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60. Dockets 5700/5702, Order of 2/06/95 at 10.

discontinue marketing efforts, including AT&T and most recently MCI which is in the process of being acquired by Verizon.[61] As Competitive Local Exchange Carriers's exit, Verizon has been able to maintain its dominant position in the marketplace. As result, we conclude that there is not currently a continuing and urgent need to allow recovery of invested capital as quickly as the Board has allowed in past years.

Depreciation Study

Verizon asserts that any requirement to update its depreciation study would be inappropriate because the link between earnings and prices has been severed under alternative regulation.[62] Therefore, the results of a depreciation study would not produce pertinent information, according to Verizon.

The Department did not specifically address the need for an updated depreciation study.

Contrary to Verizon's assertions, the linkage between earnings and rates has not been completely severed. Since implementation of the current incentive plan in 2000, the Company has been required to submit monthly earnings reports with the Department and the Board. Included in these reports are depreciation charges that reflect depreciation rates, which in large part, were developed as far back as 1987. The record evidence clearly indicates that these earnings have been shielded by aggressive depreciation rates and lenient accounting of plant investments that have been fully depreciated but remain on the Company's accounts. The current aggressive depreciation rates have resulted in over-collection. Irrespective of the methods we use to regulate Verizon, it is still our obligation to assure customers that the rates the Company charges for services are reasonable. As such, current depreciation studies serve a useful purpose as they help us determine appropriate charges. Since the last depreciation study was completed, technologies used in the provision of service have changed. The useful lives of various assets may have also changed. As such, we conclude that the depreciation rates need to be updated to reflect new technologies which have been deployed. We also conclude a new study is necessary in order to determine an appropriate cost for removing assets from service. We agree with

61. Exh. DPS-CJC-1 at 2-8 (2004 Telecommunications Plan).
62. Verizon Brief at 31.

Verizon that it would be unfair to reduce rates in this proceeding based on a requirement to file a depreciation study it had no reason to know about. As such, Verizon should submit a complete and thorough depreciation study for review by the Board and the Department no later than 12 months prior to the end of this successor plan.

Cost of Removing Assets (Adjustment #2)

Findings

30. SFAS #143 requires companies to record the estimated future cost of removing assets over the life of the asset, if such assets are "legally" required to be removed in the future. O'Quinn reb. pf. at 18–20.

31. For assets which are not legally required to be removed, SFAS #143 states that the estimated future cost of removal shall not be recognized until the cost of removal is actually incurred in the future. O'Quinn reb. pf. at 18.

32. Prior to the implementation of SFAS #143, companies, such as Verizon, included the estimated future cost of removal in current depreciation expenses. With the adoption of SFAS #143, this policy was prohibited for financial reporting purposes. Ostrander pf. at 38.

33. Verizon determined in 2003 that the Company generally did not have a legal obligation to remove long-lived assets as described by SFAS #143. As a result of this determination, Verizon started to record the cost of removal only when such costs were actually incurred and when the cost of removal was projected to exceed the salvage value of the asset being removed. O'Quinn reb. pf. at 18–19.

34. In connection with the adoption of SFAS #143, Verizon was required to reverse previously accrued removal costs in excess of salvage values. The cumulative impact of reversing past accruals resulted in Verizon Corporate recording a one-time gain of $3.5 billion in 2003. Verizon-New England's portion of this one-time gain amounted to $609.3 million. Verizon's portion of the gain amounted to $45.6 million.[63] O'Quinn reb. pf. at 19; Ostrander pf. at 40–43.

63. Net of adjustments and jurisdictional separations.

35. The amount of depreciation accrued over the life of an asset is equal to its original installed cost, minus net salvage value. Net salvage values are calculated as the difference between the gross salvage value at the time the asset is retired and the cost of removing the asset. O'Quinn reb. pf. at 22; exh. Verizon-7; finding 19, above.

Discussion

Incumbent LECs traditionally accrued the estimated future cost of removing assets over their expected lives. They did this by collecting depreciation on the asset until the total accumulated depreciation associated with that asset equaled its cost minus future net salvage.[64] This practice changed in 2003 when SFAS #143 was implemented for financial accounting. Under SFAS #143, companies, like Verizon, that do not have a legal obligation to remove assets are now prohibited from annually accruing such removal costs when the estimated cost of removal exceeds the estimated salvage value of the asset. Verizon, like other incumbent LEC's, must now record the actual cost of removal when the cost is incurred.[65]

Verizon determined in 2003 that the Company generally did not have a legal obligation to remove long-lived assets as described under SFAS #143. As a result, Verizon started recording the cost of removal only when such costs were actually incurred and when the cost of removal was projected to exceed the salvage value of the assets to be removed. Verizon was also required to reverse previously accrued removal costs.[66] The cumulative effect of reversing prior year's collections resulted in a one-time gain of approximately $45.6 million for Verizon in 2003.

The Department recommends increasing Verizon's earnings by $9.12 million annually over the next five years in order to return to customers the one-time gain. According to the Department, the election to implement SFAS #143 had a positive impact on the operations of Verizon. Furthermore, the Department argues that the proposed adjustment poses no identifiable harm to the Company as the adjustment simply amortizes the $45.6 million one-time gain over a

64. In most cases, future net salvage values were negative, so that depreciation expense recovered more than the gross cost of the asset.

65. If, however, the estimated cost of removal is less than the estimated salvage value, SFAS #143 allows Companies to continue accruing removal costs as before.

66. O'Quinn reb. pf. at 19, citing Verizon New England 2003 SEC Form 10-K.

five-year period while simultaneously reducing depreciation.[67] The Department also asserts that the inter-generational equity is preserved as it is not recommending to eliminate the Future Net Salvage rate from depreciation charges. Rather, the Department is asking the Board to require Verizon to maintain side records that would show the effect of eliminating the cost of removal from depreciation without actually changing the depreciation rates.[68] Finally, the Department asserts that its proposal does not violate the prohibition against retroactive ratemaking.

Verizon contends that the Department's recommendation is unwarranted. According to Verizon, implementation of SFAS #143 for financial reporting purposes does not mean that the traditional regulatory practice of collecting removal costs from current customers over the expected life of an asset has been discredited. In contrast to the Department's position, Verizon also asserts that the Department's recommendation conflicts with the prohibition against retro-active ratemaking.

Adoption of SFAS #143 for financial reporting purposes does not obviate the regulatory principle of maintaining inter-generational equity. While the effect of adopting SFAS #143 may have resulted in a one-time benefit that flowed to the bottom line of the Company's financial books, the benefit is a temporary one. The Company will still incur removal expenses sometime in the future. Therefore, based on the record evidence, we find the Department's recommendation to be unfair as it would have the effect of requiring future customers to pay for the cost of removing assets which were not used for the provision of their services.

As we have discussed in previous orders, maintaining inter-generational equity is an important policy goal. While we acknowledge the Department's concerns about the potential effects of implementing SFAS#143 and that it may not have imposed any financial harm on the Company, we conclude that preserving inter-generational equity promotes the general good of the state. The issue before us is not whether our decision affects Verizon but is instead whether inter-generational equity has been maintained. In accordance with this policy, we conclude that Verizon shall include in rates a reasonable estimate of the future cost of removing assets from service.

67. Department Brief at 34.

68. Department Reply Brief at 13.

The Department is correct in stating that this proceeding is not a formal rate case as described under 30 V.S.A. §§ 225 and 227 but is instead a proceeding guided by 30 V.S.A. § 226b. However, the Department's assertion that the ban against retroactive ratemaking is lifted under § 226b is misguided. Section 226b(e) states, in relevant part, that:

> In reviewing a petition to approve alternative forms of regulation, the Board shall follow procedures substantially similar to those contained in Sections 225, 226 and 227. . . .

Under the concept of substantial similarity, we conclude that the prohibition against retroactive ratemaking still applies in this proceeding. Moreover, for the reasons stated above, we find that postponing the collection of removal costs to another generation of customers would not promote the general good of the state.

The Department has also identified an important policy issue regarding the distinction between estimated future net salvage values, which are collected from current customers through depreciation charges, and actual net salvage costs when assets are retired from service. The distinction is important because a portion of the depreciation charge includes a prepayment of future expected removal costs that may or may not actually be incurred. In order to assure current and future customers that they will only pay for costs that are reasonably expected to occur, the Department recommends that the Board require Verizon to track (and report separately) funds collected for the purpose of paying for removal expenses from all other funds collected through depreciation charges. In this Order, we direct Verizon to conduct a new depreciation study of all assets used in the provision of intrastate telecommunications services. As a result, it is unnecessary for Verizon to report to the Board and the Department collections for net salvage values. As Verizon updates its depreciation study, the Company will be required to maintain its own records that will show the differences between past estimated removal costs that have been collected in current rates and actual removal costs. Based on this exercise, the updated study depreciation charge will reflect more recent costs of removal.

Yellow Pages Revenue (Adjustment No. 3)

Findings

36. Directory advertising revenues, such as Yellow Pages revenues, are derived from the sale of directory advertising. Nestor reb. pf. at 63.

37. Verizon's predecessor (New England Telephone & Telegraph Company ("NET")) transferred the telephone directory publishing operations and associated assets to a new unregulated affiliate (NYNEX Information Resources Company) as part of divestiture in 1984.[69] Nestor reb. pf. at 72.

38. Following the transfer, NYNEX Information Resources Company provided a guaranteed flow of directory publishing revenues to NET. Initially, this was provided under a 1984 Directory Publishing Agreement ("1984 DLA"). Nestor reb. pf. at 73.

39. The Board included an adjustment of $7 million in its cost of service in Docket 6167 to reflect the amount of Yellow Pages revenues that Verizon received. Ostrander pf. at 55.

40. The $7 million amount included in Docket 6167 was based on the amount actually recorded on Verizon's books in the June 1998 test year. It reflected revenues received pursuant to a 1991 Directory Publishing Agreement ("1991 DLA") between Verizon New England and its affiliate, Verizon Yellow Pages Company. Docket 6167 Order at 38, n.132; O'Quinn reb. pf. at 25; Nestor reb. pf. at 63; tr. 4/26/06 at 191–192, 210 (O'Quinn).

41. Verizon terminated the 1991 DLA effective January 1, 1999, which included provisions for revenue sharing by Verizon Yellow Pages Company. Docket 6167 Order at 39; Nestor reb. pf. at 66; tr. 4/27/05 at 40 (Nestor).

42. At the time Verizon terminated the 1991 DLA, the regulated entity did not receive any compensation for the value ratepayers had previously provided to the directory publishing affiliate. Tr. 4/26/05 at 206 (O'Quinn).

43. Verizon replaced the 1991 DLA with agreements in 2000 and 2003 that included only a fee-for-service and did not provide for revenue sharing. Nestor reb. pf. at 71.

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69. NET was a part of NYNEX, one of the original seven Regional Bell Operating Companies. NYNEX subsequently merged with Bell Atlantic, another Regional Bell Operating Company, then later with GTE to form Verizon, Inc.

44. In Vermont, there are currently six independent directory publishers offering thirteen directories in competition with eight Verizon VT directories. These directories also compete for advertising revenue with other media, including electronic directories. Nestor reb. pf. at 84.

Discussion

Prior to divestiture of AT&T in 1984, the directory publishing functions were part of regulated telephone company operations. As we described it at that time:

> Historically NET has published a directory, listing the names, addresses and phone numbers of its residential and business customers. Included in this directory are advertising and separate listings for business customers known as 'Yellow Pages.' This function is an integral part of providing telecommunications services to Vermont's ratepayers. Historically the cost and revenues associated with directory services have been included in the cost of service. The revenues exceeded costs, sometimes to a substantial degree, making a contribution to the overall costs of NET.[70]

With divestiture, NET created a separate unregulated affiliate and transferred the directory publishing operations to the affiliate, including the Yellow Pages. Notwithstanding the substantial value to the regulated company, NET transferred the assets at net book value.[71] NET also put in place the 1984 DLA under which it provided a portion of the earnings from its Yellow Pages affiliate to the regulated company.

Verizon continued to share a portion of its earnings from Yellow Pages with its regulated operations through 1999, under the 1984 DLA and its successor, the 1999 DLA.[72] The Board reflected the revenue sharing from the directory publishing affiliate in retail rates. In 1999, however, Verizon decided to terminate the 1991 DLA, including the payments to regulated

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70. Dockets 4784/4785, Order of 10/5/84 at 78.

71. Dockets 4784/4785, Order of 10/5/84 at 59.

72. Verizon also continues to provide this support during the period following the expiration of the 1984 DLA and before adoption of the second agreement.

operations.[73] In its place, Verizon instituted fee-for-service agreements in 2000 and 2003 that did not include revenue sharing mechanisms.[74]

In its assessment of Verizon's earnings, the Department asks the Board to continue to include $7 million that we had included in rates in the last two litigated reviews of Verizon's rates. The Department maintains that the simple fact that Verizon cancelled the 1991 DLA does not support removal of the revenue, particularly since the directory publishing affiliate continues to enjoy all of the benefits it obtained under that DLA. The Department points to the fact that the directory publishing affiliate had paid Verizon annual amounts in exchange for use of the local exchange company's name and logo in publishing and distributing directories, soliciting advertising, and labeling directories. The Department also states that, under the 1991 DLA, Verizon had agreed not to compete against the directory publishing affiliate.[75] According to the Department, the termination of the 1991 DLA ended the revenue sharing that benefitted ratepayers, but did not alter any of the benefits that had previously flowed to the directory publishing affiliate.[76]

Verizon argues that the cancellation of the 1991 DLA occurred because of FCC mandates, not to simply terminate a revenue stream that had supported rates. Verizon asserts that its "ability to derive the revenue stream from the 1991 DLA ended due to a 1999 FCC Order."[77] This Order, contends the Company, forced Verizon to replace its previous revenue-sharing agreement with a new publishing agreement. Verizon also states that Vermont ratepayers do not pay for the value that Verizon Yellow Pages derives from its association with the regulated entity.[78] Finally, Verizon argues that the imputation of Yellow Pages revenues as recommended by the Department is inconsistent with Board precedent; the Company maintains that, absent a directory publishing agreement that includes a revenue sharing provision or legal and factual

73. In Dockets 6167/6189, the Board (without objection from Verizon) also included $7 million in its assessment of Verizon's anticipated retail rates for calendar year 2000, even though this period occurred after Verizon terminated the 1991 DLA. Dockets 6167/6189, Order of 3/24/00 at 39–40.

74. Nestor reb. pf. at 71.

75. Department Brief at 38.

76. Department Brief at 39.

77. Verizon Brief at 40.

78. Nestor reb. pf. at 72.

support for imputation, the Board has no valid basis for including non-regulated directory revenues in Verizon's intrastate rates.[79]

We decline to adjust Verizon's cost-of-service as requested by the Department. At the time of divestiture and the inception of the 1984 and 1991 directory publishing agreements, the Yellow Pages business was available for competitive entry, but few alternatives to Verizon's Yellow Pages existed. Moreover, the expectation at the time of divestiture was that regulated ratepayers would continue to receive a share of the revenues from directory publishing as they had previously, particularly since they received no monetary compensation at the time the directory publishing agreement was separated.

Over time, however, the Yellow Pages business has become open to competition. In Vermont, Verizon now faces a number of independent directory publishers and other web-based directories that compete with Verizon's own directories.[80] In addition, the FCC has placed limitations on the manner in which Verizon represents its directories, so that Verizon can no longer claim the Yellow Pages to be official. The factual basis for our previous decisions has also changed. In 1999, Verizon terminated the 1991 DLA, which obligated the directory publishing affiliate to share revenues with the regulated entity. Thus, the legal mandate upon the affiliate to provide such compensation no longer exists.

In light of these facts, and the passage of twenty years since divestiture, we are not persuaded that we should require Verizon to impute revenues that it will not receive and that are not consistent with a competitive framework. We recognize that there is no evidence that the decision to terminate revenue-sharing was the result of an arms-length transaction. Nonetheless, the Department has not presented sufficient proof that ratepayers are entitled to continue to receive a share of such revenues or that they have not been fully compensated already for the full value of the yellow pages affiliate.[81]

We are, however, troubled by one aspect of Verizon's existing directory publishing arrangements. At the present time, Verizon publishes a single directory with both yellow and

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79. Verizon Brief at 44–46.

80. Nestor reb. pf. at 84.

81. The Department could have sought such information in discovery; Verizon would have no valid basis for objecting to its provision.

white pages, all under the Verizon name and employing its logo, which is then commonly bound and distributed together. Thus, despite Verizon's assertion that its Yellow Pages business is separate, and that it terminated payments in 1999 because of this separation, in fact the white and yellow pages are integrally linked. To all but the most sophisticated users, even though Verizon can no longer claim the Yellow Pages to be the official directory of the regulated company, the joint publishing and distribution of the directories creates a very different factual impression — one that is inconsistent with the idea that the directory publishing affiliate and regulated entity are truly separate. As the Department has shown, Verizon may have decided to terminate the 1991 DLA, but the single directory provides its affiliate with almost all of the same benefits for which that affiliate previously provided significant annual compensation, including the benefits of the tradename.[82]

If, as Verizon asserts, the Yellow Pages affiliate is a separate entity operating in a competitive environment, it should not be able to continue to leverage the value of the white pages and the regulated company without providing compensation for that value. At the present time, Verizon provides a white pages directory to all of its customers as part of the basic phone service. Because the Yellow Pages are bound into a single directory with the white pages and jointly distributed, the Yellow Pages affiliate is not truly operating separately. To be consistent with our conclusion to reject the Department's recommendation because Yellow Pages is a separate, unregulated affiliate operating in a competitive environment, Verizon must make the separation in the directories real so that consumers and advertisers do not receive the current signal that the Yellow Pages is part of the regulated telephone operations. Accordingly, beginning with the next cycle of directory publishing, Verizon should separate the white pages from the Yellow Pages. It should also distribute the two sets of directories separately. In

82. Verizon has argued that the value of the name "Verizon" arises from the corporation, not the regulated entity and that, as a result, ratepayers provided no contribution. This argument appears to rest upon the fact that the name Verizon was adopted following the merger of GTE and Bell Atlantic and did not previously have name recognition. While Verizon is correct that the name was new, we can accept Verizon's assertions only if we ignore history and common sense. The name Verizon enjoyed instant recognition in the telecommunications industry and for consumers. This arose because consumers knew that it was simply Bell Atlantic and GTE operating under a new name — the value existed due to the years of operation as a basic exchange telephone company, not from something created by Verizon's corporate headquarters. Verizon's joint marketing of its Yellow Pages continues to leverage the value of the regulated telephone company.

addition, it should, during the sale of advertising, inform advertisers that the directories will, in the future, be separately bound and distributed.

In the alternative, we will permit Verizon to continue the current joint publishing and distribution. However, if Verizon elects not to separate the white and yellow pages and distribute the two books separately, then we will presume that Verizon continues to see economic value from the combined publishing and distribution, including that flowing from the connection to the regulated operations. In this case, it is appropriate for ratepayers to receive a portion of that value. Thus, if Verizon opts to continue joint publishing and distribution, we will adopt the Department's recommended $7 million adjustment.[83]

We have no evidence on the timing of Verizon's directory publishing. However, it is likely that, even if Verizon decided to separate the directories, that decision could not be implemented immediately. Therefore, for purposes of evaluating Verizon's earnings, we will make no adjustment to the cost-of-service at this time. If Verizon informs us that it will separate the directories in the future, no adjustment is appropriate, for the reasons set out herein. If, Verizon elects to continue joint publishing and distribution, then for purposes of calculating rate adjustments necessary during the term of the 2005–2008 Plan, Verizon must include $7 million for each relevant year.

Jurisdictional Allocation of Unregulated Assets (Adjustment No. 13)

Findings

45. Verizon's intrastate regulatory accounts include investments and expenses related to the provision of Frame Relay and Asynchronous Transfer Mode services. Brevitz pf. at 103–104.

46. Verizon's interstate tariff identifies both Asynchronous Transfer Mode and Frame Relay services as special access services. Brevitz pf. at 104; Brevitz surr. pf. at 48.

47. Based on Verizon's interstate tariff, if less than 10% of the total traffic over the facilities used in the provision of Frame Relay and Asynchronous Transfer Mode services is considered to

83. Verizon shall inform the Board of its choice no later than January 31, 2006, although the Company may provide its response earlier.

be intrastate in nature, then the entire service is determined to be interstate. Brevitz pf. at 104 (citing Verizon FCC Tariff No. 1, Original Page 2-24 and 2-25, Effective April 28, 2001).

48. Prior to May 22, Verizon directly assigned costs for Frame Relay and Asynchronous Transfer Mode Services to the intrastate and interstate jurisdictions. Brevitz pf. at 109.

49. By Order dated May 22, 2001, the FCC "froze" the jurisdictional separation factors used to allocate the investments, revenues and expenses of Verizon and other local exchange carriers subject to price cap regulation. These factors are used to separate (or allocate) the investments, revenues and expenses of carriers between interstate and intrastate jurisdictions. Brevitz pf. at 87 (citing *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, Report and Order*, CC Docket 80-286, FCC 01-162, 5/22/01 (the "*Freeze Order*").

50. Pursuant to the *Freeze Order*, ILECS are required to continue assigning investments, revenues and expenses (or portions thereof) in an identical manner as they have traditionally done so prior to the issuance of the May 22nd Order. This means that if such investments, revenues and expenses (or portions thereof) were previously directly assigned to either the interstate or intrastate jurisdictions prior to the issuance of the *Freeze Order*, then ILECs are required to continue to direct assignment of such investments, revenues and expenses in the same manner after the issuance of the May 22nd Order. Brevitz pf. at 88 (citing the *Freeze Order*).

51. At the same time that Verizon has assigned 70 percent of the costs to the intrastate jurisdiction, it has allocated all of the revenues to the interstate jurisdiction. Brevitz pf. at 93, 103.

52. The FCC's cost allocation procedures have not been properly applied to Verizon's special access accounts (i.e., cable and wire facilities and central office equipment) that are used to provision services like Frame Relay and Asynchronous Transfer Mode. As a result, the Company's intrastate investments, revenues and expenses have been overstated. Brevitz pf. at 94, 97.

53. The number of special access lines have more than doubled since 2000 (and more than quadrupled since 1999) but the directly assigned investment in interstate special access services has substantially remained the same over the same time period. Brevitz pf. at 96–97.

Discussion

Pursuant to Part 36 of the FCC's rules, Incumbent LEC's are required to allocate investments, revenues and expenses to either the interstate or intrastate jurisdictions. Where possible, these costs are directly assigned in their entirety to either one jurisdiction or the other. If costs cannot be directly assigned to a jurisdiction, then such costs are apportioned between the two according to the FCC's separation factors. These factors were "frozen" in 2001.

Under the freeze, investments, revenues and expenses that were subject to direct assignment before the freeze must be updated annually.[84] The FCC rules emphasize the importance of this requirement by repeating it with regard to several particular categories of plant, including loops[85] and switching equipment.[86] The *Freeze Order* also emphasized that direct assignment would not cease during the freeze:

> Categories or portions of categories that have been directly assigned in the past, however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned. Since those portions of facilities that are utilized exclusively for services within the state or interstate jurisdiction are readily identifiable, we believe that the continuation of direct assignment of costs will not be a burden on carriers, nor will it adversely impact the stability of separations results throughout the freeze.[87]

In summary, during the freeze, ILECS including Verizon are required to annually update their directly assigned accounts under Part 36, just as they did before the freeze.[88]

The fundamental principle underlining the FCC's cost allocation process is to match the Company's investments, revenues and expenses with an identifiable operation or a service used by customers and to categorize them as either an interstate or intrastate service. Of the two assignment procedures, direct assignment is the preferred methodology.

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84. 47 C.F.R. § 36.3(a).

85. The annual update requirement applies to loops, known in separations parlance as "Exchange Line Cable and Wire Facilities, Category 1." 47 C.F.R. § 36.154(g).

86. The annual update requirement applies to tandem switching equipment, 47 C.F.R. §§ 125(d), local switching equipment, 47 C.F.R. §§ 126(c)(4), interexchange circuit equipment, host/remote circuit equipment, 47 C.F.R. §§ 126(e)(4), and information origination and termination equipment, 47 C.F.R. § 36.142(c).

87. *Freeze Order*, para. 23 (footnote omitted).

88. *See also* Brevitz pf. at 88.

The Department contends that Verizon failed to properly assign to the interstate jurisdiction investments of $3.212 million that are used to provide Frame Relay and Asynchronous Transfer Mode services, and $720,718 in associated annual expenses. According to the Department, Verizon directly assigned these costs prior to the issuance of the FCC's *Freeze Order*.[89] Thus, Verizon is required to continue assigning these costs in the same manner. Rather than comply with the FCC's Order, Verizon has instead allocated roughly 70 percent of the incremental Frame Relay and Asynchronous Transfer Mode costs to the intrastate jurisdiction while at the same time allocating incremental revenues to the interstate jurisdiction.[90] As a result, intrastate customers are paying for the majority of these services. The Department recommends that the Board remove the investments and expenses associated with the provision of Frame Relay and Asynchronous Transfer Mode switching services from the intrastate accounts of the Company.

Verizon states that Asynchronous Transfer Mode and Frame relay services are jurisdictionally mixed. As such, a portion of the costs related to these services must be assigned to the interstate jurisdiction and a portion to intrastate. Moreover, Verizon contends that a Board Order in Docket 6594 requiring the Company to file intrastate Asynchronous Transfer Mode and Frame Relay tariffs provides the Company with the authority to assign approximately 70% of the costs to the intrastate jurisdiction. Finally, Verizon contends that the Department's recommendation is in conflict with the FCC's May 22nd Order and should be rejected.

The FCC's "Freeze" Order requires the Company to continue directly assigning those investments, revenues and expenses associated with services like Frame Relay and Asynchronous Transfer Mode switching to the interstate jurisdiction if the Company had previously done so prior to the issuance of the Order, unless sufficient documentation has been presented indicating that the traffic being transmitted by these services is now predominately intrastate in nature. Verizon did not provide such documentation during this proceeding.

By allocating roughly 70 percent of the cost of new Asynchronous Transfer Mode and Frame Relay services to Vermont ratepayers, while at the same time recording the revenues on

89. Brevitz pf. at 109.

90. Brevitz pf. at 93.

the Company's interstate accounts, Verizon has produced a revenue-cost mismatch. This allows Verizon to increase its interstate profits, while imposing incremental provisioning costs on basic service customers who have few if any alternatives. This action was precisely the harm that the FCC foresaw (and wanted to prevent) when it adopted the freeze and repeatedly mandated annual updates to special access accounts.

Moreover, the record evidence indicates that Verizon's employees who are charged with the responsibility of complying with FCC rules determined in May, 2001 that the intent of the Freeze Order was to "continue to develop special access/private lines costs [in] the same way we do today in our facilities process. "[91] This leads us to conclude that Verizon understood the ramifications of the Freeze Order that required the Company to continue to directly assign special access services, such as Asynchronous Transfer Mode and Frame Relay, to the interstate jurisdiction. We find it disturbing that Verizon has disregarded the advice of its own separations expert.

Verizon's argument that the Company was allowed to allocate roughly 70% of the costs of providing Frame Relay and Asynchronous Transfer Mode services to the intrastate jurisdiction pursuant to our Order in Docket 6594 is misplaced. In Docket 6594, we found that the transfer of assets used to provide advanced data services (now referred to as special access services), like Frame Relay and Asynchronous Transfer Mode switching, from a Verizon affiliate to Verizon was in the public good. Our Order in that Docket required the Company to file revisions to its tariffs to include the existing services of Verizon's affiliate within one week of the completion of the transaction. That requirement assured existing customers of Verizon's affiliate that the transfer of assets would not affect the terms of their service after the transfer was complete. The Order did not confirm the jurisdictional nature of the services being provided today, as Verizon asserts. The Order is instead silent as to how investments, revenues and expenses are allocated between jurisdictions. The issue in this proceeding is not whether Verizon can allocate investments, revenues and expenses to the intrastate jurisdiction but is instead an issue of creating a revenue-cost mismatch. As stated above, Verizon has allocated 70% of the costs of

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91. Exh DPS-DB-9 at 4.

the aforementioned services but not the revenues.[92] This is an unfair result. Therefore, we direct Verizon to remove $3.212 million in investments, and $720,718 in annual expenses associated with special access services, such as Asynchronous Transfer Mode and Frame Relay, from the Company's intrastate cost of service.

Affiliate Charges (Adjustment No. 15)

Findings

54. Verizon Services Group ("VSG") and Verizon Services Corporation ("VSC") (together referred to as "Verizon affiliates") provide management services to Verizon and other operating affiliates.[93] VSG and VSC bill Verizon for services rendered on a monthly basis. O'Quinn reb. pf. at 41; tr. 4/28/05 at 100–101 (Ostrander).

55. The affiliates generate revenues exclusively from Verizon's operating companies, like Verizon . O'Quinn reb. pf. at 42; Ostrander pf. at 97.

56. The Verizon affiliate charges are assessed at costs plus a mark up. Because the rate of return on affiliate investments exceeds the rate of return for intrastate operations, the amount of the mark-up passed on to Verizon is excessive. Ostrander pf. at 92.

57. Verizon affiliate charges to Verizon amounted to $46.3 million, $38.8 million, $39.8 million and $51.3 million in 2000, 2001, 2002 and 2003, respectively. Ostrander pf. at 93.

58. 47 C.F.R. § 32.27 (c) states that for services sold or transferred to a carrier from its affiliate, the services shall be recorded at no more than the lower of fair market value and fully distributed costs. Ostrander pf. at 95; 47 C.F.R. 32.27 (c).

Discussion

VSG and VSC provide centralized management services to Verizon and other operating LECs. VSG and VSC bill the Company for the services rendered on a monthly basis. The total

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92. Brevitz pf. at 103.

93. VSG appears to be another name for Telesector Resources Group. Tr. 4/28/05 at 100 (Ostrander); Ostrander pf. at 98.

charges billed by the Verizon affiliates are assigned to Verizon either directly or according to an indirect method based on allocation factors such as the operating LEC's revenues or assets.

Using financial data provided by the Company, the Department calculated the return on investment for both VSG and VSC. As a result of its analysis, the Department asserts that the affiliate charges from VSG and VSC to Verizon are excessive because the affiliate companies earned extraordinary returns.[94] The Department recommends a reduction in the cost of service by an amount that is equal to these excess charges. The proposed amount of the reduction is $3,168,863. The Department also states that its earnings return calculations are reliable and accurate, whereas Verizon's are not because the Company did not provide the information necessary to verify their calculations.

Verizon contends that the Department's adjustment is incorrect because the Department misapplies the "end of period" concept by comparing the 12-month year end investment balance of the affiliates to their net operating incomes even though the affiliates submit their charges to Verizon separately each month during the 2003 test year. According to Verizon, the correct method of determining the earnings return of the affiliate companies is to instead compute the returns on a monthly basis and then average these returns in order to determine the annual return. Verizon also contends that the Department misinterprets the FCC's rules governing affiliate transactions. According to Verizon, the affiliates are exempt from the FCC rules and the charges from the affiliates should be assessed to operating LEC's according to fully distributed cost methodologies. Verizon also asserts that the Department overstates the amount of the proposed adjustment because Verizon represents only about 1% of the Company's total operations instead of the 6-8% estimated by the Department.[95]

47 C.F.R. § 32.27(c) states that "services sold or transferred to a carrier from its affiliate, shall be recorded at no more than the lower of fair market value and fully distributed costs."

In this proceeding, Verizon has not presented a good faith estimate of the fair market value of the services provided by the affiliate companies. Additionally, in light of the high rates of return on investments, it is apparent that the practice of marking-up affiliate costs is not in the

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94. Department Brief at 61–62.

95. Verizon Brief at 47.

best interests of Vermont customers. It is also apparent that in recent years, the amount of the charges passed on to Verizon have increased at an extraordinary rate even though Verizon's asset values have decreased. The Company has neither provided a reasonable explanation in support of these recent increases nor explained how Vermont customers benefit from the services provided by the affiliate companies. Based on these high returns, and the absence of a fair market determination, the Board therefore concludes that the affiliate charges are unreasonable and should not be recovered from captive customers.

The Board also concludes that the Department's 6-8 % allocation factor is a reasonable approximation of the excess earnings attributable to Verizon operations. We base our decision on the documentation presented by the Department, which in turn was provided by Verizon during discovery. We conclude that the Company's assertions that the Department's adjustment contains errors is unpersuasive. The Company did not provide sufficient documentation to adequately support an alternative methodology. The documentation that Verizon did provide on rebuttal, which we note was different from the information the Company originally provided to the Department, could not be verified by the Department. The total costs that Verizon used in its allocation factor did not match the total costs contained in the financial statements of the Verizon affiliate companies.[96]

Finally, we find Verizon's argument regarding the use of an average rate base calculation to determine the earnings of Verizon's affiliate companies to be unpersuasive. In past proceedings, the Board has relied on the end of period analysis for the purpose of assessing the earnings of Verizon. There is nothing in the record that persuades us that a change in previous methodologies is warranted. As a matter of consistency, we, therefore, conclude that a similar methodology is appropriate for Verizon's affiliate companies. Moreover, in light of Verizon's declining rate base over recent years, the end of period methodology results in a better representation of the appropriate level of earnings than would a 12-month average methodology. Therefore, we adopt the Department's recommendation to reduce expenses by $3,168,863.

96. Ostrander surr. pf. at 54.

Employee Severance Cost Reductions (Adjustment No. 18)

Findings

59. The average number of employees has been reduced as part of cost saving measures that Verizon has implemented over recent years. These reductions have resulted in known and measurable reductions in the cost of service. Dittermore pf. at 21.

Discussion

Over the years, Verizon has implemented a number of cost savings measures, including workforce reductions. As the average number of Verizon employees declines, the cost of providing services also declines. The Department proposes to adjust Verizon's cost-of-service to account for the smaller number of employees.

The parties agree with the principles underlining the Department's adjustment. However, Verizon asserts that the Department's adjustment of $5.516 million is overstated. According to Verizon, the monthly earnings statements that the Company filed with the Board in November and December, 2003, already reflected the anticipated costs savings from reduced payroll numbers. As such, Verizon maintains that the Department has double counted the expected cost savings for the last two months of 2003.

According to the Department, its analysis represents an annualized level of incremental savings as a result of the Company's severance plan. The employee cost savings adjustment, argues the Department, simply compares the annualized level of costs based on the reduced level of employees with the actual cost incurred in 2003. As such, there could not be any double counting as the Department's adjustment is effectively reduced by the level of actual 2003 savings achieved in those two months.

We conclude that as a result of reduced levels of employment, Verizon's actual cost of service is $5.516 million less than the level it has claimed. The record evidence leads us to conclude that the Department's analysis of the severance savings was not overstated. In comparing the actual costs incurred in 2003 to annualized costs based on reduced employee levels, the Department properly captured the annualized effect of the portion of the savings that have been included in the Board's earnings reports for November and December, 2003. In essence, the amount of the Department's proposed annualized adjustment is reduced by averaging the costs over the course of the year, including the reduced costs in the months of November and December, 2003.

Wage and Salary Increases (Adjustment No. 19)

Findings

60. Known and measurable changes to Verizon's cost of service include increases in wages and salaries effective in 2004. Dittmore pf. at 24–25.

Discussion

The parties agree that known and measurable changes in employee wages will result in a slight increase in the Company's cost of service. The proposed wage increase was compared to the results of an independent compensation study provided by Verizon. Based on this comparison, the Department determined that Verizon's proposed percentage increase for wages was appropriate. The Department then applied the percentage wage increase to salary and wages reported in the Company's earnings reports submitted to the Board.[97] In deriving its total proposed adjustment, the Department also considered the impact of reduced employee levels.

Verizon asserts that the Department has understated the amount of the wage increase for the same reasons that its proposed adjustment for 2003 employee severance savings was overstated.

Effective in 2004, the increases in wages and salaries will result in a known and measurable change in Verizon's cost of service. As such, the adjustment of $85,000 to Verizon's cost-of-service suggested by the Department is just and reasonable. We find Verizon's assertion with regard to understating the amount of the wage increase to be unpersuasive for the same reasons stated above. Again, in comparing the actual wages paid in 2003 to the annualized wages based on expected employee levels, the Department properly captured the annualized effect of the portion of the wage increases that have been included in the Board's earnings reports for November and December, 2003.

97. The proposed wage increase adjustment omitted severance payments in 2003.

Regulatory Cost Amortization(Adjustment No. 23)

Findings

61. Anticipated regulatory expenses of this proceeding are expected to be $541,440. Dittemore pf. at 32.

62. These anticipated expenses would be subject to jurisdictional separations. O'Quinn reb. pf. at 48.

Discussion

For this proceeding, Verizon anticipates incurring regulatory expenses of $541,440. The Department recommends amortizing the amount of these anticipated regulatory expenses over a five-year period which results in an increase of $108,288 in the cost of service. Verizon does not contest the five -year amortization period but states that a portion of the expenses will be subject to separations. As a result, the Company recommends an adjustment of $76,657.

As the parties are in agreement over the amount of the expected regulatory expenses, we find that Verizon's proposed increase of $76,657 is a known and measurable change in the cost of service.

Corporate Enhancement Advertising (Adjustment No. 24)

Findings

63. Verizon's advertising costs included expenses related to marketing and corporate enhancement activities. Dittemore pf. at 32.

64. Corporate enhancement expenses are discretionary in nature that are unnecessary in the provision of regulated services. Dittemore pf. at 32.

Discussion

Corporate enhancement activities are intended to elevate the name recognition of the corporation and enhance its public image in the minds of customers. These activities are separate and distinct from marketing activities that attempt to educate customers about the Company's services. In this proceeding, the parties disagree over whether expenses associated with corporate enhancement activities result in customer benefits.

The Department asserts corporate enhancement activities are unnecessary in the provision of regulated services and, therefore, recommends a $1,008,654 reduction in the cost of service. The Department also contends that the expenditures are more likely to benefit Verizon's unregulated operations and that Verizon has not presented sufficient documentation supporting its contention that the activities are necessary to win-back customers.

Verizon disagrees with the proposed adjustment. In contrast to the Department's position, Verizon argues that corporate enhancement activities are necessary in today's competitive environment. According to Verizon, the Company must spend an appropriate amount of funds to elevate its image in order to retain and win-back customers.

Verizon is a well-known corporation with operations in most areas of the United States. Operating on a national scale most likely requires the Company to spend equity capital on corporate enhancement activities. These activities, however, bear no relation to the provision of regulated local exchange services in Vermont. As such, we conclude that while an appropriate amount of marketing expenses may be necessary, there is no basis to conclude that corporate enhancement expenditures result in customer benefits.

Arguably, spending funds to win-back customers who have left the company for an alternative carrier may produce some benefits by lowering the average cost of service for all customers. It is equally rational, however, to argue that Verizon's shareholders assume the risk associated with competition and have been compensated for that risk in the form of a higher rate of return on equity capital. Under this paradigm, shareholders bear the burden of win-back costs. In addition, there is a significant probability that if the Board were to allow Verizon to spend funds generated from regulated customer revenues to enhance the Company's image, we would be approving a subsidy that would support Verizon's unregulated services at the expense of Verizon's regulated customers. Such a result would be in violation of 30 V.S.A. § 218. Therefore, based on the record evidence and to prevent any potential subsidy of competitive services, we conclude that expenses associated with corporate enhancement do not produce a tangible benefit for Verizon's local exchange customers. Thus, we adopt the Department's recommendation to eliminate corporate enhancement expense for the purpose of determining the Company's cost of service.

2. Rate Base Adjustments

Accumulated Depreciation- SFAS #143 (Adjustment No. 2)

Discussion

We addressed this issue above in Section III.1.B. For the reasons stated there, the Board declines to adopt the Department's proposed adjustment and order Verizon to issue customer credits associated with the Company's SFAS #143 election.

Jurisdictional Allocation of Unregulated Assets (Adjustment No. 13)

Discussion

Consistent with our ruling above, the Board adopts the Department's proposed adjustment to remove from rate base $3.212 million in special access investments used to provision services such as Asynchronous Transfer Mode and Frame Relay.

Accumulated Deferred Income Taxes (Adjustment No. 25)

Findings

65. Deferred tax assets and liabilities arise from differences between the recognition of income taxes for financial reporting purposes (booked taxes) and taxes actually paid pursuant to IRS regulations. There are numerous differences between accounting requirements set forth in Generally Accepted Accounting Principles ("GAAP") and those reflected in the IRS regulations, including the cost basis of assets, depreciable lives of assets, as well as differences between the recognition of certain costs (accrual versus cash basis accounting). Dittemore surr. pf. at 13.

66. Verizon did not adjust its deferred tax asset balance for regulatory purposes to reflect the amortization of past severance costs in a manner that is consistent with previous Board Orders. Dittemore surr. pf. at 13.

67. Instead of amortizing severance payments, the cost of employee severance has been expensed by Verizon in the year the expense was incurred. The effect of expensing such costs

deflate book income relative to taxable income and affects the recognition of deferred taxes. Dittemore surr. pf. at 13.

68. Deferred tax assets are created when taxable income exceeds book income. Dittemore surr. pf. at 13.

Discussion

Accumulated deferred tax assets and liabilities are created as a result of differences in income taxes reported for financial reporting purposes and the income taxes actually paid. Deferred Tax assets indicate that the Company has recognized more taxable income than its book income and, as a result, has accrued additional income taxes that will be paid in the future. Such recognition of additional income taxes represent an asset upon which the Company earns a return. A deferred tax liability represents, in essence, a prepayment from customers to the Company for income taxes that will be (or are reasonably expected to be) paid in the future. Such funds reduce the Company's rate base. In this proceeding, the parties disagree over whether Verizon has appropriately accounted for severance costs and whether the treatment of such costs affected the amount of the current Deferred Tax asset of $18,047,120.

The Department recommends that the Board ignore the Company's current deferred tax asset because Verizon has not been complying with previous Board Orders requiring the amortization of severance payments. Had the Company amortized severance expenses, the deferred tax asset balance would have been offset, according to the Department, by the tax effects of amortizing severance expenses. Due to uncertainty over the amount of the accumulated deferred taxes that would have been recorded had Verizon actually complied with previous Board Orders, the Department recommends that the Board simply ignore the current Deferred Tax asset in Verizon's regulatory accounts.

Without commenting on whether the Company has complied with previous Board Orders, Verizon asserts that the Department's adjustment is speculative because the Department developed its latest recommendation on surrebuttal after discovering an error in its original adjustment. As such, the recommendation should be rejected, according to Verizon.

Verizon has the burden of proof. In accordance with the Board's ruling in Docket 5132, the Department only has to present sufficient evidence to overcome the presumption that Verizon's current rates are just and reasonable. Once that presumption has been burst, then the burden to persuade the Board of the reasonableness of its rates shifts back to the Company. This is in accordance with the so-called Thayer Rule, or bursting bubble theory of presumptions.[98] Based on the record evidence, the Department has shown that Verizon has not been amortizing past severance payments equal to approximately $30 million[99] in accordance with the Board's practices. As a result, the Company's deferred tax asset may be overstated by a significant amount. Had the Company amortized these severance payments in accordance with the Board's practices, then the deferred tax balance could have been reduced by $12 million.[100] Therefore, in the absence of evidence in support of the Company's recommendation, we find the Department's adjustment to rate base to be a reasonable remedy.

Working Capital (Adjustment No. 26)

Findings

69. In 2003, Verizon's rate base reflects a higher monetary value for employee withholding liabilities than reported on the Company's trial balance accounts. Dittemore pf. at 34.

70. Employee withholdings represent funds deducted from employee wages by Verizon for the payment of income taxes and other employee liabilities. Dittemore pf. at 34.

Discussion

Working capital represents funds used during the daily operations of the Company. To the extent working capital belongs to shareholders, it is appropriate to include in rates, a return on these funds. In this proceeding, the parties have differing opinions on the amount of Company funds that qualify as working capital.

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98. Docket 5132, Order of 6/20/86 at 3–7.

99. Tr. 4/28/05 at 27 (Dittemore).

100. Tr. 4/28/05 at 26–27 (Dittemore).

The Department contends that, according to the Company's trial balances, Verizon reports to have collected from its employees more funds to pay for future employee liabilities than the Company expects to actually pay out. These excess funds represent cost-free capital to the Company. As such, the Department recommends that the rate base be reduced by $519,211 in order to prevent customers from paying Verizon a return on funds that are cost-free.

Verizon asserts that because the Department's adjustment is based on a Verizon trial balance, instead of the Company's payroll databases, the proposed adjustment fails to accurately reflect Verizon withholdings. Therefore, the Company recommends that the Board reject the Department's proposed adjustment.

Verizon has not provided a reasonable explanation as to why Verizon's trial balance should be markedly different than its payroll database. We assume that reports of employee withholdings should be reasonably comparable regardless of the reporting mechanism. As such, we conclude that the Department's recommendation is a legitimate remedy that protects customers from paying a return on capital that is otherwise cost-free.

3. Uncontested Cost of Service and Rate Base Issues

At the start of this proceeding, the parties disagreed on how to resolve several cost of service and rate base issues. As time progressed, however, compromises were reached and the parties were able to settle their differences of opinion on several but not all issues. On the issues that Verizon and the Department reached an agreement, we make the following findings of fact.

Distance Learning Network (Adjustment No. 4)

Findings

71. Pursuant to the Board's Order in Docket No. 6167, expenses related to Distance Learning Network (DLN) should not be paid by ratepayers, but instead should be funded by Verizon's (f/k/a Bell Atlantic-Vermont) shareholders. Ostrander pf. at 71.

72. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 26.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's proposed adjustment. Therefore, in accordance with the Board's Order in Docket 6167, Verizon should remove the expenses related to the operation of the Company's distance learning network from the cost of service.[101]

Access Revenues (Adjustment No. 5)

Findings

73. On November 14, 2003, Verizon filed with the Department an adjustment to reflect a reduction in access revenues in the amount of $161,000. Ostrander pf. at 75.

74. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 26.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

Retail Penalty Credits (Adjustment No. 6)

Findings

75. In 2002, Verizon incurred retail compensation penalties in the amount of $970,000. The penalties were reflected on the Company's 2003 books via reductions in local revenues for residential and business customers. Ostrander pf. at 76.

76. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn surr. pf. at 27.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

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101. Ostrander pf. direct at 71.

Wholesale Penalty Credits (Adjustment No. 7)

Findings

77. In 2003, Verizon did not comply with the wholesale service quality standards under the Company's Performance Assurance Plan. As a result, Verizon was required to accrue $424,047 to reflect an estimate of the penalties to be credited to wholesale customers.[102] The penalty relates to wholesale penalties accrued on the Company's 2003 books, but paid in the 2004 period. Ostrander pf. at 77.

78. Verizon does not contest this adjustment for purposes of calculating a cost of service but contends that a portion of the penalties should be allocated to the interstate jurisdiction. O'Quinn reb. pf. at 27.

79. The Department does not contest Verizon's alternative proposal to allocate the penalty to both the interstate and intrastate jurisdictions. As a result, the Department's revised revenue adjustment is $298,953. Ostrander surr. pf. at 50.

Discussion

The Department has revised its proposed adjustment and appropriately allocated the penalty between the intrastate and interstate jurisdictions. Thus, the Board adopts the Department's proposed adjustment as revised. The Company's revenues should be increased by $298,953 for the purpose of establishing the cost of service.

High Cost Support Revenues (Adjustment No. 8)

Findings

80. The Company's test year revenues included customer credits and high cost support funds previously embedded in service rates. The amount of the revenues received in 2003 that exceed high cost support amounts to $373,887. Ostrander pf. at 79–80.

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102. Under the Performance Assurance Plan, Verizon issues credits on the bills of Wholesale customers rather than pay each customer a pro-rata share of the penalty in the form of a check. Thus, in order to account for the credit for the purpose of determining the Company's cost of service, it is necessary to increase revenues.

81. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 27–28.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

Reciprocal Compensation (Adjustment No. 9)

Findings

82. Reciprocal compensation and access expense represent revenues and expenses that carriers pay each other for originating and terminating their respective customers' calls or data traffic. Ostrander pf. at 80–82 (Confidential).

83. In order to normalize and reduce non-recurring entries on the Company's books, it is necessary to reduce reciprocal compensation and access expense by $2,100,000 in order to reflect an appropriate cost of service on a going-forward basis. Ostrander pf. at 80.

84. Verizon does not contest this adjustment and agreed to remove all reciprocal compensation costs from the test period cost of service. O'Quinn reb. pf. at 29.

Discussion

Because the parties are in agreement regarding the effect of this adjustment, the Board adopts the Department's adjustment as proposed.

Removal of ARMIS Related Revenues and Expenses (Adjustment No. 10)

Findings

85. ARMIS related adjustments consist of four parts. It removes from the cost of service: (1) ARMIS non-regulated expenses of $8,875,000; (2) ARMIS non-regulated revenues of $7,282,000; (3) ARMIS non-regulated Total Plant in Service and amortizable assets of $7,160,000; and (4) ARMIS non-regulated accumulated depreciation reserve of $3,734,000. Ostrander pf. at 83.

86. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 29.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

Directory Assistance Revenues (Adjustment No. 11)

Discussion

After further discussing their concerns about Directory Assistance revenues with the Company, the Department withdrew its proposal. As such, there is no longer a need for the Board to rule on this issue.

Rent Revenue (Adjustment No. 12)

Discussion

Because the Department's concerns regarding rent revenues were addressed by Verizon, the Department withdrew its proposed increase in miscellaneous rent revenues. As such, there is no longer a need for the Board to rule on this issue.

Transition Benefit Obligation ("TBO") Amortization (Adjustment No. 16)

Findings

87. SFAS #106 is a rule that requires Verizon to account for non-pension benefits on an accrual basis rather than a cash basis.[103] Dittemore pf. at 4.

88. One element of the computation of SFAS #106 is referred to as the Transition Benefit Obligation. The Transition Benefit Obligation represents the net present value of the costs of future benefits earned by employee and retirees. Dittemore pf. at 4.

103. Such benefits are provided to employees and retirees of the Company.

89. Under SFAS #106, Verizon has the option to recognize these costs immediately in one year or amortize such costs over future periods not to exceed twenty years. Verizon chose the later option. Dittemore pf. at 4.

90. In 2001, Verizon made an unapproved change in the recognition of its transition benefit obligation expenses. The change had the effect of shielding the Company's earnings. In order to reverse Verizon's unapproved change in the recognition of these expenses and to amortize the net present value costs over the appropriate 20-year period, the Company's expenses should be reduced by $935,517 on an intrastate basis. The details of the Transition Benefit Obligation amortization adjustment are set forth in Exhibit DPS-DND-2 (proprietary). Dittemore pf. at 3–7; exh. DPS-DND-2 (proprietary).

91. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 44–45.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

Severance Payments (Adjustment No. 17)

Findings

92. The Department originally proposed an adjustment to operating expenses of $11,261,055 to reflect the net impact of eliminating 2003 severance costs from test year operating results and adjusting the Company's cost of service to reflect recognition of amortizing 2002 and 2003 severance costs over a five-year period. Dittemore pf. at 7–8.

Discussion

The Department proposes an adjustment of $9,832,019 in intrastate 2003 Operating Expenses to reflect the net impact of eliminating 2003 severance costs from test year operating results.[104] Verizon does not contest the Department's revised adjustment. As such, the Board adopts the Department's adjustment as revised.

Pension Benefit Expenses (Adjustment No. 20)

Discussion

The Department originally proposed to increase Pension benefit expenses by $4,533,795. The Company asserts that increases in the amount of $5,238,733 were known and measurable. On surrebuttal, the Department agreed with Verizon's assertions and withdrew its original proposed adjustment. As such, there is no longer a need for the Board to rule on this issue.

Arbitration Expenses (Adjustment No. 21)

Findings

93. Verizon's test year expenses included $445,977 of intrastate costs associated with expenses accrued as a result of an arbitrator's ruling that Verizon improperly terminated employees in 2003. These costs should be removed from the Company's cost of service. Dittemore pf. at 30.

94. Verizon does not contest this adjustment for purposes of calculating a cost of service. O'Quinn reb. pf. at 47–48.

Discussion

Because Verizon does not contest this adjustment, the Board adopts the Department's adjustment as proposed.

104. The details of the modified adjustment are reflected in Exh. VZ-KJO, Sch. 3 (propertiary).

Labor Contingency Expenses (Adjustment No. 22)

Findings

95. Verizon's test year included so-called contingency costs in preparation for an anticipated workforce strike. Dittemore pf. at 31; exh. DPS-DND-11.[105]

96. During the test year, a labor agreement was reached. As result, the Company avoided a strike by employees. Dittemore pf. at 31; exh. DPS-DND-11.

Discussion

The Department removed costs related to labor contingency costs because these costs are non-recurring. Verizon does not contest the proposed adjusment. As such, the Board adopts the Department's adjustment as proposed.

4. Cost of Capital

Findings

97. Verizon's capital structure, rates for each capital component of the capital structure and weighted-average cost of capital is:

Description	Ratio	Cost Rate	Weighted Average Cost of Capital
Long Term Debt	43.50%	6.95%	3.02%
Short Term Debt	2.50%	1.13%	0.03%
Common Equity	54.00%	10.50%	5.67%
Total	100.00%		8.72%

Exh. DPS-DCP-14.

98. An allowed return on equity of 10.50 percent adequately compensates investors, given the level of perceived risks in Verizon's business. Parcell pf. at 19–20.

99. Over the past three years, both long-term and short-term interest rates have declined to their lowest levels since the 1950's. Parcell pf. at 9.

105. Costs are deemed to be confidential. Department Brief at 71.

100. Capital costs, including equity costs, are at their lowest levels in over three decades. Parcell pf. at 10.

101. The common equity ratio of Verizon-New England, Verizon's parent company, has declined over the five-year period ending in 2003 as shown in the table below:

Year	Common Equity
1999	50.40%
2000	47.20%
2001	43.40%
2002	36.60%
2003	28.90%

Parcell pf. at 14.

102. The common equity ratio of similarly-situated telephone companies approximates 53.5 percent. Parcell pf. at 15.

Discussion

As we have stated in previous Board Orders, there are three essential steps we follow in setting the weighted average cost of capital. First, we determine an appropriate capital structure. Second, we determine the cost of each capital component. And, third, we determine the cost of each capital component according to its proportion of the total capital structure. The sum of these weighted capital components is the weighted-average cost of capital. In these proceedings, the parties have a difference of opinion on the capital structure, the cost of debt and the cost of equity.

Capital Structure

The optimal capital structure of a typical firm consists of both equity and debt, which results in the lowest possible costs. Debt is less expensive than equity, however, there are limits to the amount of debt that can be used to finance utility operations before equity investors begin to demand higher returns as compensation for assuming additional financial leverage risks. Therefore, an appropriate amount of equity is necessary to minimize overall capital costs.

In this proceeding, Verizon maintains that an appropriate capital structure includes 75% equity and 25% debt. The Company's position rests on the premise that investors use the market value of equity and debt to estimate their required rates of return.[106] In accordance with this approach, Verizon obtained the total current market value of the outstanding common shares[107] of its proxy groups and used the average of these results to support the Company's contention that a 75% equity structure was appropriate.[108] The Company followed the same procedure to estimate the market value of outstanding debt for these same proxy groups and, based on that analysis, Verizon contends that a 25% debt structure is appropriate.

The Department asserts that a capital structure consisting of 54% common equity, 43.5% long term debt, and 2.5% short term debt is appropriate. The Department argues that this structure is a reasonable approximation of the capital structure of similar-situated telecommunications companies. In addition, it represents the same debt-equity ratio that the Board adopted in Dockets 6167/6189.[109]

Proxy groups that include the S&P Industrials and other Regional Bell Holding Companies are inappropriate for determining the capital structure for a company like Verizon. Such companies are subjected to far greater degrees of competition than Verizon's local exchange business. [110] Additionally, we find Verizon's market capitalization approach has no tangible connection to the actual capital structure of Verizon-New England and does not reflect how the Company actually chooses to finance its operations.[111] As such, Verizon's proposal to establish a capital structure consisting of 75% equity and 25% debt does not reflect a known and measurable change in the cost of service. As we noted above, the actual equity ratio of Verizon-

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106. Verizon Brief at 51.

107. The total market value of common equity is determined by multiplying the number of outstanding common shares times the per share price as of a specific point in time.

108. The results of the study show that the actual market value equity structures were 84% and 82% for the S&P Industrials and the Regional Bell Holding Companies, respectively.

109. *See* Docket 6167, Order of 3/24/00 at 69.

110. See Docket 6167, Order of 3/24/00 at 74.

111. It is worth noting here that Verizon does not report a separate capital structure as it is instead subsumed within the capital structure of Verizon-New England.

New England has plummeted in recent years from 50.4 percent to 28.9 percent at the same time Verizon's (Corporate) equity in its consolidated operations has increased.[112] This can only mean that capital that would have otherwise been available for investment in Vermont has been redirected to Verizon's corporate parent. As equity capital has declined, we conclude that it would be inappropriate to base Verizon's weighted-average cost of capital on a target capital structure as proposed by Verizon . Such an approach would lead to higher revenues than would be necessary and inappropriately compensate investors for equity capital that does not actually exist. Instead, we find that a capital structure consisting of 54% common equity, 43.5% long term debt, and 2.5% short term debt strikes a fair balance and serves as a form of incentive to encourage Verizon to invest more equity capital in Vermont than is currently available.

<u>Cost of Equity</u>

There are no objective measures of investors' expected rate of return on equity capital. Therefore, the Board must exercise its judgement in setting an appropriate cost of equity for rate-making purposes. The Board, however, is not without guidance. As in past cases, we rely on principles established more than eighty years ago to help us determine a cost of equity that strikes a balance between the interests of both ratepayers and investors.

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[113]

These principles are reflected in the statutes governing the Board's decisions, and have been endorsed repeatedly by the Vermont Supreme Court. *See, e.g.*, *Petition of Village of*

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112. Parcell pf. at 14.

113. *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-93 (1923). *See also Duquesne Light Company v. Barasch*, 488 U.S. 299, 310 (1989).

Hardwick Electric Department, 143 Vt. 437, 442 (1983); *In re Green Mountain Power Corp*., 131 Vt. 284, 298 (1973); *Letourneau v. Citizens Utilities Co*., 128 Vt. 129, 132-33 (1969).

Similarly, there is no specific model or approach to determining the cost of equity. The Company and the Department have presented the results of several models. Verizon's models estimate a cost of equity of 13.46%. Meanwhile, the Department asserts that based on its various methodologies, a cost of equity ranging from 10.0 to 11.0 percent is appropriate, with a mid-point of 10.5 percent. Irrespective of the approach we rely on to determine an appropriate cost of equity, all that is required of us is to authorize a cost of equity that is fair and reasonable to all stakeholders. It is not necessarily the method used to establish an appropriate return on equity that is important but the end result.

Verizon asserts that the Department's cost of equity analyses are flawed and, therefore, should be rejected. According to Verizon, the Department erred in the use of proxy companies and understates the growth component of the DCF methodology. In addition, Verizon asks the Board to take official notice of a recent Moody's Investor Services report issued on May 20, 2005. In that report, Moody's downgraded the debt ratings for Verizon-New England.

The Department asserts that a 10.5% cost of equity is appropriate. In developing its recommendation, the Department relied on three widely accepted methodologies[114] and two proxy groups consisting of both telecommunications and Local Distribution gas companies ("LDC"). The Department also contends that its recommendation is further supported by the fact that long-term interest rates are much lower today than when the Board issued its first incentive regulation plan in 2000.

<u>Proxy Groups</u>

Verizon contends that the Department's telecommunication proxy groups should be rejected because it includes only six companies. According to Verizon, this group is too small to provide reliable results. In support of its assertion, the Company points to a finding in Docket

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114. The methodologies include the Discount Cash Flow Model, the Capital Asset Pricing Methodology and the Comparable Earnings Approach.

5983 where the Board determined that a proxy group should be of "sufficient size to minimize the effects of vagaries of individual companies within the sample."[115]

According to the Department, the purpose of creating a proxy group is to identify a set of companies that have similar risks and operating characteristics as the subject company.[116] In addition, the Department contends that Verizon's selection of a subset of the S&P Industrials and a group of companies meeting certain Value Line criteria is inappropriate.

Based on the record evidence, we conclude Verizon's arguments are unpersuasive because the Company's reliance on our finding in Docket 5983 is misplaced. In Docket 5983, we determined that:

> To arrive at the proper cost of capital for [for a utility], one should consider a set of comparable [ ] utility companies. One should identify a set of companies facing similar risks and market dynamics as [the utility]. It is important to *view a group of companies in order to minimize the effects of the vagaries of individual companies within the sample.*[117]

In part, we base our ruling today on the premise that proxy groups should consist of similarly-situated companies. It is not necessarily the number of companies in the group but the quality of the Companies included, as the above-captioned finding suggests. As we concluded in Docket 5983, it is important to view a group of companies, as opposed to a single company, in order to minimize the effects of an individual company on the end result. The Department's analysis has accomplished this task. In Docket 5983, the Board did not determine how many companies should be included in a proxy group. And, we will not do so here.

We also base our ruling, in substantial part, on the principles spelled out in the *Bluefield* case. In order to emphasize the foundation of our ruling, we restate the relevant parts of that opinion here:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public *equal to that generally being made at the same time and in the same general*

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115. Docket 5983, Order of 2/27/98 at 116.

116. An assertion that Verizon agrees with. Verizon Brief at 53.

117. Docket 5983, Order of 2/27/98 at 116.

> *part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.*[118]

Verizon includes a large group of companies listed on the S&P Industrials index and other Value Line companies. These companies operate businesses throughout the world and in many different types of industries. Each face various degrees of competition. In this proceeding, we are setting the cost of equity for Verizon which operates a relatively low-risk business in Vermont. The group of S&P Industrials proposed by the Company does not fit the standard of being in the "same general part of the country" and participating in "other business undertakings which are attended by corresponding risks and uncertainties." As such, we decline to accept the Company's recommendation.

Verizon criticizes the Department's recommendation because the Department reduces the results of its cost of equity analyses (in particular the Capital Asset Pricing methodology) by 100 basis points in order to reflect the allegedly lower risk that local exchange carriers face relative to the operations of their consolidated parent companies. Contrary to the Department's position, the Company asserts in this proceeding that because the parent company operates in a host of different business segments and markets, they are less risky than their local exchange subsidiaries. Therefore, the Department's recommendation should be rejected, according to the Company.

We find Verizon's argument to reject the Department's overall recommendation on the premise that its parent company is less risky than its operating affiliates is misplaced. The question before us is not whether the parent company has the ability to diversify away risks but whether our determination would fairly compensate investors of local exchange companies for the risk they assume.[119] In making our determination we are guided by the various methodologies used to estimate the cost of equity on a group of similarly situated companies and our judgement. The Department conducted its analysis using three separate and widely

118. *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-93 (1923). *See also Duquesne Light Company v. Barasch*, 488 U.S. 299, 310 (1989).

119. It is worth noting that Verizon's predecessor, Bell Atlantic Corporation, represented to the investment community in forms related to its merger with NYNEX, that the holding company as a whole is a more risky venture than its local exchange telephone operations. Docket 6167, Order of 3/24/00 at 74.

recognized methodologies. These methodologies produce a range of results that we conclude fairly compensate investors for the risk they assume. And, each of the methodologies were based on proxy groups of similarly situated companies as Verizon.

Verizon also states that the Department's use of Natural Gas Local Distribution Companies ("LDC") is not applicable today due to increased competition in the telecommunications market. According to Verizon, the Board may have correctly determined that LDC's and Verizon faced similar risks in Docket 6167. However, the circumstances have since changed and the level of competition Verizon faces is greater today than the level of competition LDC's currently face.

In Docket 6167, the Board determined that it was reasonable to assume that LDC's and Verizon faced comparable risks. That determination was based on evidence which indicated that Verizon's operating profitability were stable and increasing, its market share of local services was 99% and that reductions in toll revenues were largely offset by increased switched access revenues. The Board concluded that these operating conditions were, in general, similar to the operating conditions of LDCs. Moreover, the Board determined in 2000 that there was no indication that the advent of competition would significantly affect the Company's business risks.

The level of competition may have moderately increased over the course of the current incentive regulation plan.[120] Nonetheless, there is no indication that it has increased so substantially to warrant approval of a 13.46% cost of equity. Furthermore, operating conditions which existed in 2000 largely exist today. It is clear from the record evidence that actual operating margins are excessive, competition is not as fierce as Verizon asserts[121] and decreases in revenues have been largely offset by the declining cost of operations; i.e., workforce reductions. Based on these sets of facts, the use of LDC's in a proxy group may still be

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120. Modest increases in the level of competition are mostly in the form of wireless services and Voice over Internet Protocol. It is important, however, to acknowledge that even these forms of competition are relatively benign at this point in time. For instance, wireless coverage in Vermont is uneven and, therefore, wireless services tend to act as a complement to rather than a replacement of Verizon's wire-based local exchange service. Additionally, Voice over Internet Protocol services depend upon the availability of broadband facilities. Such facilities are not as prevalent as they should be and, as a result, the threat of competition from this type of service alternative is limited. Exh. DPS-CJC-1, pp. 4-21and 4-22 (wireless) and Figures 2.3, 2.4 at pp. 2-9 (cable coverage)

121. *See* Section V.A., below.

desirable. However, the Department's analysis of the LDC's cost of equity produced results ranging between 8.3 percent and 10.6 percent.[122] We conclude that these results are at the lower range of acceptability. We also note that in Docket No. 6929, the Department supported in 2003 an 11.25% cost of equity for Vermont Gas Systems, Inc., a cost that is markedly higher than what the Department is now estimating for local gas distribution companies.[123] Since the equity costs are lower now than in 2003, we have afforded less weight to the results of the Department's analysis of the LDC's cost of equity. As such, it not necessary to rule on the applicability of this proxy group as the Company has requested.

Discounted Cash Flow Growth ("DCF")

Verizon asserts that analysts' forecasts are the most reliable indicator of investors's expectations of future growth. In contrast to the Company's assertion, the Department asserts that its DCF analysis reflects reasonable expectations of investors and that a number of studies indicate that exclusive reliance on analysts' forecasts is a less accurate predictor of growth.

Based on the record evidence, we conclude that the Department's analysis correctly relied on a variety of growth measures which included:

- 1999-2003 (5 year average) earnings retention, or fundamental growth;
- 5 year average of historic growth in earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS);
- 2007-09 projections of earnings retention growth;
- 2002-2008 projections of EPS, DPS, and BVPS; and
- 5 year projections of EPS growth as reported in FirstCall.

The Department's combination of growth indicators consist of a robust set of estimates of investor growth expectations for a group of comparable companies.[124]

For the reasons highlighted above, we are unpersuaded by Verizon's arguments that the S&P Industrials result in a more accurate estimate of investors' expectations. This group of

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122. Parcell pf. at 20 and 23.

123. Cost of Equity was later reduced by the Board to 10.98%. *See* Docket No. 6929, Order of 10/07/03 at 4 and Proposal for Decision of September, 2003.

124. Parcell pf. at 19-20.

companies operate in much different industries than Verizon and face a greater degree of competition. As such, it would be inappropriate to establish a higher cost of equity that would unfairly compensate investors for risks that the Company does not face. Additionally, reliance on only analysts's forecasts is unjustified. These estimates are based on the opinions of analysts which are important but not the only source of information. The Department's analysis included analysts's opinions as one component of its overall estimate of expected growth. We believe that investors also view historical performance records that are just as important and that the Department has accorded sufficient weight to the opinions of analysts. As such, it is appropriate to include a variety of data sources to estimate investors' expectations of future growth. The Department's analysis includes such variety.

Ratings Action taken against Verizon Communications , Inc.

Verizon asks the Board to take official notice, pursuant to 3 V.S.A. § 810(4), of a downgrade in the investment quality ratings of Verizon-New England's senior unsecured, non-guaranteed outstanding debt obligations. According to the Moody's Credit Research rating action, the downgrade was due to concerns over the impact of line losses, high cost structures and increasing capital requirements on the ability of the Company to continue to generate pre-dividend free cash flow.

The action taken by Moody's does not warrant a change in our perception of the operating risks Verizon faces. While line losses, high relative costs and increasing needs for capital expenditures may be affecting other Verizon operating companies, the record evidence in this proceeding indicates that for Verizon line losses have not posed a threat to profitability, costs have been declining and that the rate of investment in new plant has not kept pace with the rate of depreciation. Moreover, Verizon has been reducing the amount of equity capital in Verizon-New England. As such, the downgrade should not be a surprise to Verizon. Had Verizon-New England re-invested equity capital in its operating companies, Verizon-New England might have avoided the downgrade altogether.

Basis for Decision

The fundamental issue for us to decide is whether the regulated telecom business of Verizon is more appropriately treated, for rate-making purposes, as a traditional regulated monopoly facing relatively low operating risks, or as a competitive business with business risks that typify a business operating in effectively competitive markets. Other contested issues such as the appropriate methodology for compounding dividend payments and exclusive reliance on analysts's forecasts are secondary to this underlying issue. Verizon states that the telecommunications market is without doubt more competitive today than in 2000, when the Board issued its Order in Docket 6167. We conclude otherwise. For the reasons stated above and in Section V.A, below, the level of competition has not changed substantially enough to warrant a cost of equity of 13.46 percent.

Based on the record evidence, we conclude that adopting Verizon's recommendation would result in an unfair decision that fails to strike a balance between the interests of ratepayers and investors. Therefore, we reject the Company's recommendation. Instead, we conclude that a return on equity of 10.5 percent provides Verizon with the opportunity to generate risk-adjusted returns that are comparable to similar-situated companies and assures the financial soundness of the Company.

C. Other Effects of Ending Alternative Regulation

In weighing the effects of returning to cost-of service regulation, we must also consider other typical elements of incentive regulation plans. First, the expiring Plan includes service quality standards, with compensation required if Verizon is unable to meet these standards. Under traditional regulation, Verizon would instead be subject to the service quality standards we established in Docket 5903, many of which are less stringent. Unlike the service quality regime that now exists for electric and gas utilities, these standards do not include any consequences if

Verizon fails to meet them. Consumers would thus lose the benefit of compensation when service quality is substandard.[125]

Second, Verizon would also lose the marketing flexibility that now exists. New tariff filings would be subject to prior review and possible suspension and special contracts would require prior Board approval. To the extent that the new services and special contracts are reasonable, customers who may benefit from them would experience delays before the services and terms became effective.

Third, the incentives that alternative regulation are intended to achieve would be lost. Verizon would no longer be assured of retaining the additional earnings from cost cutting measures and from introducing new services. These incentives would be replaced by the expectation that if Verizon took steps to increase its earnings, it would likely see rate proceedings designed to reduce rates so that the earnings would be passed on to ratepayers. It is possible that this would result in fewer new services.[126] These changed incentives may also diminish Verizon's deployment of new infrastructure to meet new customer expectations.[127]

IV. THE PARTIES' PROPOSED PLANS

A. The Verizon Plan

Verizon proposed that its AFOR will be in place for an initial three years, with an option for up to four additional years if Verizon, the Department, and the Board all agree. Verizon's proposal would provide it substantially greater pricing flexibility than it has under the existing Plan. The primary elements of the Plan are the following:

- The plan establishes four categories of services and the pricing treatment of each: Residential Basic Services; Residential Non-Basic Services; Retail Business Services; and Other Services.

125. This benefit of alternative regulation would not exist if we adopted Verizon's proposal, which does not include a service quality component.

126. We note, however, that the evidence shows that new services that Verizon introduced in Vermont during the Incentive Regulation Plan were also introduced in New Hampshire, which operates under traditional rate-of-return regulation. Often, this deployment occurred earlier in New Hampshire.

127. As we explain above, however, Verizon has not taken advantage of the incentives provided under the existing Plan but instead elected to delay its deployment of broadband services that consumers sought.

- Verizon may change rates, terms, and conditions for Residential Basic Services at any time, with a 10% annual limit on rate increases (except for 'exogenous events' and revenue-neutral offsets—see below).
- The Lifeline credit will be increased by an amount equal to any increase in the Residential Basic Exchange Service rate.
- Verizon may increase rates, terms, and conditions for Residential Non-Basic Services (and any new Residential Services) as well as for Retail Business Services (and any new Retail Business Services) at any time, without restriction as to the amount of the increase.
- Prices for Other Services (which include wholesale services and access charges) are subject to rate regulation.
- Cost increases (or decreases) caused by Exogenous Events may be reflected in rates, with the approval of the Board. In general terms, an Exogenous Event is one that is beyond the control of Verizon and that causes an annual change in revenues or costs of more than $1,000,000 and that is caused by a regulatory action, including changes in tax law or accounting rules, whether in Vermont or federally.
- Verizon may petition to modify the terms of the AFOR to reflect regulatory or market conditions.
- Verizon may discontinue any service, on 45 days' notice, except for Residential Basic Services and Other Services.
- Verizon will continue to file tariffs for its services. Only tariffs for Other Services will be subject to the notice and suspension provisions of 30 V.S.A. §§ 225, 226, and 227.
- Verizon's plan does not include a retail service quality plan; however, if the Board deems one to be necessary, Verizon presents a proposed new service quality plan. This plan has fewer quality metrics than the existing plan, and has no financial penalties for Verizon's failure to meet them.

B. The Department Plan

The Department proposes what it calls a Network Investment Incentive Plan that will run for three years, with the possibility of two two-year extensions. The Plan also calls for revenue reductions and for a retail service quality plan that builds upon the existing retail service quality plan.

The Department's proposal, which is similar in many ways to the present Incentive Regulation Plan, contains the following elements:

- The Department proposes to establish three categories of services, with different treatment of each: Existing Services; New Services; and Competitive Services.
- Verizon may not increase prices for existing regulated intrastate services except under specified conditions.
- Prices, terms, and conditions for New Services will be at the discretion of Verizon, provided they meet any established price floor and they do not discriminate between customers. Products and services introduced under the Docket 6167 Incentive Regulation Plan are considered New Services.
- Verizon would have flexibility to raise prices on particular services in particular local exchanges. The Board would designate both the services and the exchanges, based upon a showing that the market in that area is sufficiently competitive.
- Services for which the Board has determined there is a competitive market or for which Verizon has been found to be a non-dominant carrier pursuant to 30 V.S.A. § 227c are not subject to the Department's Plan.
- The net revenues of Verizon are to be reduced $20 million as of July 1, 2006. Further, smaller reductions will occur in subsequent years. However, the Company may avoid some or all of these reductions by making offsetting investments in its network, either by specified improvements in the diversity of network traffic routes or through projects to enable access to broadband data service in currently unserved areas.
- Like the Verizon plan, the Network Investment Incentive Plan allows the Board to order rate increases where external regulatory or legal events cause a significant increase in costs or decrease in revenues of regulated intrastate services.
- The Retail Service Quality Plan that Verizon and the Department agreed to in 1999 would continue, with the modification of certain performance metrics and the addition of others.

V. Merits of Verizon Plan, Department Plan, and Other Options

In the previous sections, we have examined Verizon's performance under the expiring Incentive Regulation Plan and the likely effects (including rate impacts) of reverting from incentive regulation to cost-of-service regulation. We turn now to consideration of the plans proposed by Verizon and the Department, both of which recommend that the Board continue incentive regulation rather than returning to rate-of-return regulation.[128] By comparison, Lightship recommends that the Board simply reject Verizon's plan, which it asserts grants too much pricing flexibility and thus permits anti-competitive behavior.

After weighing the proposals put forth by Verizon and the Department, Lightship's arguments, the past experience, and the potential effects of returning to traditional regulation, we reach the same conclusion we reached in Dockets 6167/6189 — that incentive regulation offers potentially greater benefits for Vermont ratepayers than traditional regulation. The various forms of alternative regulation provide different methods to better approximate competitive market forces and to encourage companies to respond to those forces, where they exist. The risks associated with deployment of new technology and services and the onset of competition are shifted to the Company; successful endeavors are rewarded by increased earnings (which the Company can retain). Meanwhile, ratepayers are shielded from unsuccessful ventures, the costs of which must be borne by shareholders. These incentives encourage the Company to operate more efficiently and to deploy new services and technology that will increase earnings.

Our decision does not mean that we are unconcerned about potential for anti-competitive behavior. This Board has consistently taken steps to prevent such behavior and to foster an open marketplace. These concerns can, however, be addressed through appropriate conditions that will protect competitors rather than outright rejection of incentive regulation; the discussion below sets out these conditions.

In the following sections, we examine the specific requirements that we must adopt for an incentive regulation plan to meet the statutory criteria set out in Section 226d(c). These include conditions necessary to assure that ratepayers do not pay rates at the outset of the successor plan in excess of those that are just and reasonable, unless ratepayers receive other compensating benefits. Similarly, we establish terms for deployment of new services and pricing that provide Verizon with substantial flexibility, while still ensuring that ratepayers are not adversely affected — particularly users with fewer cost-effective competitive alternatives.

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128. The 2000 Incentive Regulation Plan included an Education Plan, which Verizon had recommended the Board adopt and which the Company had argued provided value to Vermont. Neither the Department nor Verizon has proposed continuation of the Education Plan or a substitute for that proposal. The Plan we set out in this Proposed Order does not contain such a Plan.

The Board has a statutory obligation when considering any form of alternative regulation to insure that it is "consistent with the public's interests relating to appropriate quality telecommunications services."[129] In adopting the incentive regulation plan proposal offered by the parties in Docket 6167, the Board conditioned its acceptance of lesser regulation of Verizon "upon the understanding that customer service quality will be maintained or enhanced."[130] The need to ensure adequate service quality remains a fundamental public policy goal. Based upon our experience with the retail service quality plan adopted in Docket 6167 and the penalty payments resulting from service quality failures under that plan, a retail service quality plan with penalty provisions is the best method of insuring an adequate level of service quality while at the same time ensuring that customers are compensated for the failure to receive the service quality they should expect. Experience has shown that, even when penalties exist, Verizon failed to comply with a service quality plan that it recommended after negotiating the plan with the Department; it is hard to envision that service quality would be maintained in the absence of such penalties.

A robust network and advanced telecommunications technologies are essential to Vermont ratepayers. However, directing specific investments may result in shifting the investment risks from Verizon to its customers. A properly structured alternative regulation plan, on the other hand, will provide Verizon with the incentives to invest in its network and deploy new services and technologies in response to customer demand. Alternative regulation will also allow Verizon the flexibility to determine the appropriate levels of capital investment and the allocation of that capital. The 2005–2008 Plan that we set out in Attachment B to this Proposed Order sets out terms and conditions to meet the statutory mandate in 30 V.S.A. § 226(c)(6) that the Plan provide "reasonable incentives for the creation of a modern telecommunications infrastructure and the appropriate implementation of new cost-effective technologies."[131]

129. 30 V.S.A. § 226b(c)(4).

130. Docket 6167, Order of 3/24/00 at 145 (footnote omitted).

131. 30 V.S.A. § 226(c)(6).

A. Effect of Competition in Vermont

Findings

103. The telecommunications marketplace in Vermont is more competitive now than it was when the current incentive regulation plan was approved in 2000. Tr. 2/3/05 at 14 (Campbell); exh. DPS-CJC-1 (State Telecom Plan) at 8-4.

104. The telecommunications market in Vermont is now open to competition. In the Board's 2002 Advice Letter to the FCC regarding Verizon's 271 application, the Board stated that, "in [its] judgment, the Vermont local telephone markets are open to meaningful competition." Vasington reb. pf. at 45–46; Docket 6533, Recommendation Letter of 2/2/02.

105. Even with the market open to competition, barriers to entry and exit for the Vermont telecommunications market include economies of scale, product differentiation, capital requirements, sunk costs and the ability of the incumbent to effectively respond to competitive entry. Brevitz pf. at 22–23.

106. Supply elasticity is the ability of firms to change their production of a good or service in response to a change in price of that good or service. Supply elasticity considers the ease of entry for new competitors as well as the ease of expansion for existing competitors. Vasington pf. at 8–9.

107. Demand elasticity refers to the willingness and ability of a consumer to change the quantity of a good consumed in response to a change in the price of that good. In general, the demand elasticity of a good is directly related to the availability of adequate substitutes." Vasington pf. at 9.

Facilities-based competition

108. Seventy-one CLECs now do business in Vermont. Forty-six of these are also resellers of intrastate long-distance services. The CLECs include both facilities-based carriers that have invested in their own switching and fiber networks as well as carriers that compete by leasing UNEs or reselling Verizon's service offerings to compete in both the residential and business markets. Porell pf. at 4–5.

109. Service resale is one of the vehicles for competitive entry under the Act. A reseller buys the telecommunications service from the incumbent LEC at a wholesale price level, and rebrands it to resell to the retail consumer with the reseller handling retailing functions like customer inquiries and billing. Brevitz pf. at 24.

110. The ability of resale-based carriers to threaten Verizon's position is limited, since wholesale prices (and therefore the CLEC's wholesale costs) rise or fall in proportion to Verizon's retail prices. The ability of resellers to innovate or otherwise distinguish the actual service from Verizon's is also limited due to the fact that by definition the underlying service platforms are identical. Verizon still collects sufficient revenue to be economically indifferent to whether it provides retail or wholesale service. Brevitz pf. at 25–6.

111. Unbundled network elements ("UNEs") constitute another mode of market entry that is required under the Telecommunications Act of 1996. Network features, functions and capabilities are required to be provided separately or "unbundled" where technically feasible to permit competitors to use portions of the incumbent LEC's network. Brevitz pf. at 26.

112. The most significant UNEs appear to be the UNE loop facility and the UNE Platform ("UNE-P"). The UNE loop is the transmission facility between the customer's premise and the central office switch. The UNE Platform is the UNE loop provided in combination with UNE switching and transport. Brevitz pf. at 27.

113. FCC decisions have created uncertainty concerning the price and availability under just and reasonable terms and conditions of some UNEs (including local switching) as well as UNE-P. Brevitz pf. at 32–34.

114. Most of the current UNEs used to provide voice services will remain available from Verizon, although some will no longer be available at Total Element Long-Run Incremental Costs ("TELRIC") rates. Vasington reb. pf. at 51.

115. Under the revised FCC rules, many products and services that were once available to CLECs at TELRIC rates, and subject to terms and conditions imposed by the FCC or state commissions, will now be available only through commercial agreements with Verizon. These agreements impact not only the prices CLECs will pay for services, but also the terms and

conditions they will be required to purchase those services under. Brevitz surr. pf. at 27; Vasington reb. pf. at 50.

116. Several competitors have negotiated commercial agreements – known as Verizon Wholesale Advantage Agreements – that continue to make these facilities available as a UNE-P-like product at commercially-negotiated rates. Exh. DPS–20.

117. The commercial agreements require CLECs that choose to use the "UNE-P like product" to accept conditions that are uniformly disadvantageous to the CLEC. Brevitz pf. at 31–32.

118. UNE-based competition for residential customers has come primarily from the use of UNE-P. Vasington reb. pf. at 52.

119. The majority of access lines competitors now serve rely upon wholesale purchase of unbundled network elements from Verizon. These competitors' ability to provide quality retail service to their end-user customers is directly dependent on the availability and quality of wholesale service they receive from Verizon. Brevitz pf. at 61 (quoting the Vermont Telecommunications Plan at 1-29 and the FCC's *Triennial Review Order* at footnote 184).[132]

120. Almost 19,000 access lines in Vermont are being served by carriers using UNE loops and slightly more than 20,000 are being served by UNE-P. Additionally, as of June 2004, resellers were using slightly more than 10,000 resold lines in Vermont.[133] Brevitz pf. at 5; exh. DPS-33 (proprietary).

121. A portion of the decline in the number of access lines that Verizon serves is attributable to end-users switching from using a second line for dial-up internet access to high-speed access such as cable modem or DSL. This is reflected by the fact that total access lines (switched and special) for Verizon Vermont increased from 433,226 in 2000 to 471,797 in 2003 (ARMIS 43-08, Table III). Brevitz pf. at 61–62.

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132. *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket 01-338, Report and Order on Remand and Further Notice of Proposed Rulemaking (2003), FCC 03-36 ("Triennial Review Order", or "TRO".)

133. Department witness Mr. Brevitz filed testimony that reported conflicting numbers with respect to wholesale access line counts for Verizon based on the Company's June 2004 Form 477 report to the FCC. *See* Brevitz pf. at 29–30. By letter dated April 19, 2005, Verizon submitted a reconciliation which explained the differences between the numbers in Ms. Porell's testimony and the numbers relied on by Mr. Brevitz from the Company's FCC Form 477. *See* Exh. DPS-33 (proprietary).

122. CLECs have collocated in 20 of Verizon's 86 central offices, making over 50% of Verizon's access lines accessible to these CLECs. CLECs in Vermont can serve business customers in Vermont using UNE-P or a UNE-P-like product and the UNE loop ("UNE-L"). UNE-L usage in Vermont has grown considerably between 2001 and 2003, and, currently, nearly 19,000 access lines are served by carriers using UNE-L. Competing carriers also serve more than 21,000 access lines using UNE-P. Porell (Revised) pf. at 5.

123. A number of facilities-based competitors are constructing networks that permit them to compete directly with Verizon without relying on Verizon's facilities. Porell reb. pf. at 10.

124. Several CLECs own their own switches, but they rely upon Verizon for local loops and transport. Lackey pf. at 19.

125. TelCove "has a major alternative fiber network that extends through all regions of the state." Exh. DPS-CJC-1 (State Telecom Plan) at 8-6.

126. TelCove's fiber network stretches over 1,000 miles, including locations in Verizon VT's franchise area. TelCove's network provides a Point of Presence to interexchange carriers and provides an alternative to Verizon's residence and business toll services. Porell reb. pf. at 11.

127. Among CLECs, only TelCove has transport facilities that reach more than approximately 10 exchanges. Lackey pf. at 19.

128. Notwithstanding its network, TelCove does not reach many customers even in the communities that it serves. Lackey pf. at 20.

129. Competition in rural areas is more limited. Lackey pf. at 19.

130. The UNE loop offers the prospect of greater independence from Verizon (as compared to resale entry), but the geographic reach of that competition is limited to central offices where a CLEC has established and invested in collocation facilities, and committed to leasing facilities necessary to transport traffic back to the CLEC switch. Brevitz pf. at 27.

131. UNE loop-based competition is at best difficult for CLEC entry in Verizon wire centers that are designated rural because UNE loop prices are too high to allow CLECs to realize a reasonable margin when competing against Verizon's tariffed retail prices, which are uniform across all UNE density zones, i.e., statewide. Brevitz pf. at 27–28.

132. Two major competitors — AT&T and MCI — have announced that they will withdraw from marketing to residential consumers, at least in part due to uncertainty concerning UNE availability. In addition, AT&T and MCI are now being acquired by SBC and Verizon respectively, removing the two largest sources of competition for Verizon in Vermont, with Verizon being the likely purchaser of MCI. Brevitz pf. at 31; Brevitz surr. pf. at 4–5.

133. Verizon has a substantial ability to respond to competitive threats. This ability can act as a check on a potential competitor's decision to enter the Vermont market. Brevitz pf. at 19, 37.

134. Verizon estimates that under the revised UNE rules, it may be able to eventually win back as many as 80 percent of the roughly 3.6 million residential lines leased by its competitors over the next several years. Brevitz surr. pf. at 5.

Cross-platform Competition

135. Internet-based services such as Voice over Internet Protocol ("VOIP"), wireless services and cable-TV based services also provide competitive alternatives to Verizon's service. Porell pf. at 6-7; Porell reb. pf. at 9–22.

136. Generally speaking, VoIP services from these companies are priced 30-40% below traditional voice offerings provided by Verizon and other incumbent local exchange carriers ("ILECs"). Porell reb. pf. at 15.

137. Recent developments, such as number portability, service quality improvements (including 911 capabilities), and new products, are improving the attractiveness of wireless and VoIP as alternatives for wireline services. Vasington reb. pf. at 62.

138. None of these services provide full competitive pressure on Verizon, particularly since they are not available ubiquitously in Vermont. There are many areas that are not served by cable or wireless and many parts of Verizon's territory do not currently have DSL, limiting a customer's ability to select a broadband-based service such as VoIP. Campbell pf. at 16 (citing the Vermont Telecommunications Plan).

139. Services such VoIP have drawbacks. Among these drawbacks are the fact that the user must pay for a broadband connection, assuming one is available, in addition to the cost of the

service. The service tends to be less reliable than landline service, and will not work at all in the event of a power outage. There are problems with 911 services.[134] Brevitz pf. at 48–49; Brevitz surr. pf. at 19–20.

140. Some consumers are using wireless service for long distance calling as a substitute for regular long distance calling over the wireline network. However, wireless service is much more of a complement to wireline service rather than a replacement for it. Brevitz pf. at 50.

141. According to the Vermont Telecommunications Plan, 70% of residential customers believe wireless coverage is only fair to poor[135] and 59% of wireless users believe it is very important to have better wireless service.[136] Brevitz pf. at 51.

142. Cable providers appear to be the most likely source of facilities-based competition for ILECs in general, and Verizon specifically. Brevitz pf. at 53.

143. No cable companies presently offer basic exchange service. This may change once Adelphia emerges from bankruptcy. Lackey pf. at 20; Porell reb. pf. at 9–10.

144. Cable television systems do not reach everywhere Verizon serves. About two thirds of Vermont households have access to cable infrastructure. Brevitz pf. at 53.

145. Verizon is likely to face direct competition from, at most, one cable operator in any particular market. Therefore, the result, at best, would be a duopoly. Brevitz pf. at 53.

146. Broadband service continues to expand in Vermont. As of 2003, broadband was available through cable modem and/or DSL to 75.3% of the Vermont population. Exh. DPS CJC-1 (State Telecom Plan) at 3-10.

147. Broadband service is available to nearly 95 percent of customers within Chittenden county. However, it is much less available in other areas of the state, particularly the more rural areas. For example, only 10.3 percent of customers in Essex county have access to broadband service (exclusively over cable facilities) and 28 percent of customers in Grand Isle county have such access. Exh. DPS CJC-1 (State Telecom Plan) at 3-10.

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134. The Department notes that the FCC is currently attempting to address problems with VoIP and proper access to E-911 services.

135. Exh. DPS-CJC-1, Table 4.30.

136. Exh. DPS-CJC-1, Figure 4.15.

Discussion

One of the primary areas of dispute between the parties is the adequacy of competitive alternatives to prevent unjust price increases, encourage network infrastructure deployment, and preserve high service quality for Verizon's customers. In competitive markets, the ability of a company to raise rates is constrained by the presence of competitors, who can gain market share if the prices are too high. Moreover, in competitive markets, as we have previously found, prices trend towards long run marginal cost; in the telecommunications environment, which has been characterized by declining costs and embedded costs in excess of marginal cost, this creates a trend towards lower prices.

Verizon asserts that Vermont has had a highly competitive telecommunications market for years.[137] In Verizon's view, the marketplace in competition is sufficiently robust that Verizon would not be able to increase its prices above just and reasonable levels, either because existing competitors could expand service alternatives or new competitors could enter the market.[138] Similarly, Verizon maintains that, because of competition, it has an incentive to maintain high service quality and to continue to invest in its network. Verizon asserts that in assessing this issue, the Board should not look simply at the current state of competition, but the likely competitive response following a price increase by Verizon. This, says Verizon, must consider market share, supply elasticity, and demand elasticity in Vermont.[139] Moreover, the Board must examine what the market may look like if Verizon attempted to use its pricing flexibility to charge unjust and unreasonable prices.[140] According to Verizon, the most important factor for the Board to consider is supply elasticity — the ease of entry for new competitors and of expansion for existing competitors.[141] With an open marketplace, Verizon claims that supply elasticity is sufficient to create competitive pressures.

137. Porell pf. at 4.

138. Significantly, Verizon does not state what constitutes "just and reasonable" rates for purposes of this analysis. It appears that Verizon would consider rates higher than those presently in existence (which were set on the basis of costs) to still be just and reasonable, although Verizon has not explicitly outlined how much higher rates could go to still meet this standard.

139. Vasington reb. pf. at 33.

140. Vasington reb. pf. at 33.

141. Vasington reb. pf. at 43.

In support of its assertions, Verizon points to the presence of many facility-based providers in Vermont, as well as new alternatives such as wireless, VOIP, and cable-based telephony. Verizon contends that these alternatives to traditional wireline service need not be perfect substitutes in order to provide a meaningful competitive option for customers. Instead, according to Verizon "it . . . is only necessary that enough customers consider it to be an adequate alternative that it would be unprofitable in the long term for Verizon VT to charge unjust and unreasonable prices."[142]

By comparison, the Department's proposed successor plan assumes that competition is not sufficient to restrain rate increases, ensure the continuance of the service quality that existed in 2000, and lead to infrastructure deployment that meets the needs of all of Verizon's Vermont customers. The Department asserts that Verizon overstates the actual extent of competition in Vermont. Moreover, the Department contends that Verizon's reliance on cross-platform competition as an adequate substitute is misplaced, since these services (VOIP, wireless, cable telephony) "have not yet demonstrated that they are a ubiquitous substitute for traditional local exchange users in Vermont."[143]

The Department also questions the adequacy of facilities-based competition using UNE's purchased from Verizon, particularly since the FCC has allowed Verizon to discontinue offering certain UNEs, including UNE-P. The Department asserts that the commercial agreements under which Verizon now offers these elements should be cause for concern. Finally, the Department maintains that Verizon has not sufficiently considered a number of factors that inhibit competitors. These include: a) the presence and nature (or absence) of barriers to entry or exit; b) the presence and nature (or absence) of significant sunk costs; c) the competitive dynamics under the Telecommunications Act of 1996, including the extent to which UNE inputs are available in the future; d) Verizon's ability to respond to competition; e) the extent to which the services cited by Verizon as "competitive" are substitutable for Verizon services; and, f) the inherent weaknesses in Verizon's supply elasticity argument.[144]

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142. Vasington reb. pf. at 57, 60; Verizon Findings at 69.
143. Department Brief at 117.
144. Brevitz pf. at 17–19.

Telephone competition has existed in Vermont for a number of years, with the Board permitting competition for toll service in 1986; it expanded to local exchange service in 1995 and has continued to grow as the Board opened the Vermont marketplace to a full range of competitors. At the outset of the expiring Incentive Regulation Plan, many competitors existed, primarily for toll service and business local service. Over the term of the Plan, this growth has continued, as evidenced by the drop in the number of access lines that Verizon serves.[145]

At the present time, the Vermont marketplace is open to competition. We recognized this fact in 2002, when we commented to the FCC on Verizon's petition for authorization to provide long distance services under Section 271 of the Act. Our Letter to the FCC stated that, "in our judgment, the Vermont local telephone markets are open to meaningful competition." [146] Similarly, the FCC found that the "barriers to competitive entry in the local exchange markets have been removed and the local exchange markets today are open to competition" in Vermont.[147]

The presence of numerous competitors supports our earlier finding that the market is open. Seventy-one competitive local exchange carriers now offer some services in Vermont. Although many of these CLECs do not actually compete with Verizon in Vermont or offer an array of services similar to those of the Company,[148] a number offer some measure of meaningful competition either through the resale of Verizon's services or by facilities-based competition (generally using unbundled network elements purchased by Verizon). Facilities-based competition, which had been primarily for toll services and high-end business customers has now expanded to a broader range of customers, including residential customers. For example, the Department's Telecommunications Plan shows that MCI now serves approximately 5 percent of the residential market.[149] In addition to competitors providing facilities-based competition, wireless and VoIP providers now offer competing packages. These services have a

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145. Part of the drop in access lines is attributable to the advent of broadband services which reduced or obviated the need for many consumers to purchase a second access line.

146. Docket 6533, Recommendation of 2/2/02.

147. Nestor pf. at 3.

148. Brevitz pf. at 66.

149. Exh. DPS-CJC-1 at 4-9.

noticeable impact on usage services, as they often bundle usage (both toll and local message service) into their offerings.

These competing services (as well as Verizon's own broadband offerings) have directly affected Verizon. Line counts, which had been growing steadily at the time we adopted the Incentive Regulation Plan, have now dropped. Growth in usage services slowed as well, first as users switched to broadband-based internet access (reducing local measured service use) and then as first wireless and then VoIP provided alternatives. This trend is likely to continue.

This trend in competition offers Vermont ratepayers alternatives to Verizon's services. It has also had some effect upon Verizon's revenues, particularly compared to expectations in the absence of competition. The evidence thus supports the conclusion that competition now exists in Vermont, but the fundamental question for us is whether the present competition and the ability of new competitors to enter the market is sufficient to prevent Verizon from using pricing flexibility to charge and sustain unjust and unreasonable prices.[150]

Verizon has not shown, however, that either the existing levels of competition, or the competition that can be reasonably be expected to occur during the course of a successor alternative regulation plan if Verizon raised rates or diminished service quality are sufficient to constrain prices. This occurs in part due to limitations in the manner of competition and in part due to the fact that competitors still serve only a relatively small portion of the marketplace.

The advent of competition does not necessarily translate into lost revenues for Verizon (except in the sense of lost opportunities) or pressure to lower rates. Competition is not a zero-sum game, particularly when one considers complementary services such as wireless. Competition has led to increased opportunities and increased usage.[151]

Facilities-based competition, while noticeable, remains limited, both geographically and by customer class. In the case of competition for residential service, at the present time, it exists primarily on the basis of UNE-P purchased from Verizon. Moreover, virtually all residential competition exists in the urban or suburban zones where prices for UNE-P are lower. Considering the FCC's recent ruling that Verizon did not need to continue to offer UNE-P, the

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150. Vasington reb. pf. at 12.

151. Tr. 1/31/05 at 77–78 (Porell).

extent of this competition in the future is questionable. We recognize that Verizon has stated that it will continue to offer UNE-P through commercial agreements, which may assist competitors. The price is likely to be higher and the evidence shows that Verizon imposes significant conditions on purchases under commercial agreements — conditions that place further limits on competition.[152] Price increases alone may eliminate or seriously reduce competition.[153]

Further limiting competition is the fact that the two largest providers of competition in the residential market — AT&T Communications and MCI — have announced plans to discontinue marketing to residential customers. In addition, MCI (by far the largest competitor for residential service) is being acquired by Verizon.[154]

The evidence also shows that competition in rural areas is quite limited in both residential and business areas. Due to geographic deaveraging of UNE rates, these elements are more expensive in rural areas. This makes it more difficult for CLECs to compete in these areas, particularly since Verizon's retail rates remain averaged.[155]

Cross-platform competition from services such as VoIP and wireless also has limitations. Wireless service is unavailable in many areas of the state due to the absence of cell towers. Moreover, customers generally view wireless as a complement to, rather than a substitute for, landline telephone service. VoIP also is limited because it relies upon an underlying broadband connection which many customers do not have available. It is also generally viewed as having lower quality than landline service. Further, VoIP does not yet reliably transmit E-911 locational information. Many of these hurdles are being addressed and, doubtless, VoIP-based competition will strengthen. But it is not now sufficient to prevent Verizon from increasing prices.

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152. Brevitz pf. at 31–32.

153. The fact that competitors have chosen not to use UNE-P in rural areas to offer residential services suggests that the price sensitivity is significant.

154. Brevitz pf. at 31; Brevitz surr. pf. at 4–5.

155. Brevitz pf. at 27–28. Verizon asserts that while maintaining geographically averaged rates may limit competition in rural areas, it also serves to transfer the competitive pressures upon rates in the urban and suburban areas to the less populous regions. If Verizon must keep rates low in the urban areas due to competition, that geographic averaging requires keeping the rates low in rural areas. Vasington reb. pf. at 34. This argument has some merit. At the same time, the limited competition in rural areas shields a substantial portion of Verizon's service territory from effective competition.

Verizon has also pointed to competition from cable providers. For the moment, such competition is prospective only. No cable company now offers telephone services (although cable-based broadband services are the platform for many users of VoIP). Once the sale of Adelphia is completed, it is possible that cable will emerge as a robust competitor. For the moment, it is not.

Finally, Verizon asserts that the actual level of competition is less important than the fact that new competitors can enter the market (and existing competitors can expand their services) if Verizon increases prices. According to Verizon, the fact that the market is open creates conditions for relatively easy entry and expansion, *i.e.*, a relatively high degree of supply elasticity.[156] The expectation of new or expanded entry, argues Verizon, will keep prices in check.

We find no evidence to support this conclusion. In fact, the only direct comparison presented in hearings would suggest the opposite. Rhode Island is a low-cost state with a highly concentrated population. As a result, it provides a much greater foundation for competition — competitors can easily obtain access to the majority of the customers in the state. Yet even there, Verizon has increased the basic rates by the maximum amount permitted by the plan each year. It is possible that Verizon's basic rates there are below costs so that increases are cost-based; we do not know. But absence such a showing, the Rhode Island example would suggest that the prospect of competition does not put a damper on price increases, at least for the less elastic services such as basic exchange rates.

We are also skeptical of Verizon's underlying assumption that price increases are appropriate. Telecommunications has generally been a declining-cost industry. As such, the expectation is that, over time, prices will decline, not increase. The experience in Vermont confirms this view; over the last 15–20 years, rates for Verizon and nearly every other incumbent local exchange carrier have declined. There is no reason to expect that this trend will not continue. In fact, in light of the drop in the underlying costs, the ability to raise rates at all (except to rebalance them) suggests the absence of adequate competitive pressure. In addition, we note that the rates for Verizon (like other incumbent local exchange carriers) have been

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156. Vasington reb. pf. at 45–46.

reviewed by the Board and determined to be just and reasonable. Rate increases are likely to lead to rates that no longer meet this statutory standard.

Overall, Verizon has been unable to support its claim that competition is now adequate to constrain price increases. The Company also raises two policy arguments that, it says, should prompt the Board to allow Verizon the pricing flexibility it seeks. First, Verizon states that the pricing flexibility is consistent with the alternative regulation plans adopted in other states, such as Rhode Island and Massachusetts.[157] In addition, Verizon maintains that the Department's assertions concerning the inadequacy of competition and the need for continued limits on pricing flexibility are inconsistent with its positions in the legislature in which it supported legislation that would permit pricing flexibility for the independent telephone companies, even though they are not subject to facilities-based competition and are not required to offer resold services or unbundled elements.[158] Verizon suggests that, out of fairness, we should allow similar pricing flexibility. The Department refutes Verizon's reliance on the experience in other states, stating that that experience does not support its claim that competition is adequate; in at least one of those states, Verizon has almost always raised its prices to the maximum extent allowed.[159]

We also find Verizon's reliance upon the absence of price controls in alternative regulation plans in other states carries no weight. It is impossible to meaningfully compare one set of conditions without a broader context. For example, we do not have any evidence as to the rate structure in those states; rates may have been set below cost, so that rate increases might be appropriate in a competitive environment. Similarly, there is no evidence as to the specific competitive conditions in those states. It is entirely possible that competition is greater in those states, and can thereby constrain prices. The record is inadequate.

Furthermore, Verizon testified that the rate increases permitted in Rhode Island and Massachusetts were designed to encourage competition.[160] This justification appears to mistakenly assume that competition is the goal, as opposed to being the chosen mechanism for achieving the actual goal of high quality service at low cost. We have opened the Vermont

157. Verizon Brief at 85–86.

158. Verizon Brief at 92 (citing tr. 4/29/05 at 92–93 (Lackey)).

159. Department Brief at 117.

160. Tr. 1/31/05 at130–131 (Nestor).

telecommunications market to competitors not simply to benefit those competitors. Rather, we concluded that the competitive market was more likely over time to lead to new services, innovation, high service quality, and low rates than would continued reliance on a single provider. To that end, we have taken many steps to achieve a level playing field. However, we have consistently resisted requests that we artificially stimulate the competitive marketplace. Unless it can be shown that rates are below their long-run marginal cost, however, increasing basic rates to encourage competition represents an artificial pricing adjustment.[161] Other states may have made such an adjustment; we decline to do so here.

We are also unpersuaded that any inconsistency between the Department's opposition to pricing flexibility here and its support for pricing flexibility for the independent local exchange carriers should alter our ruling. Our duty is to base our decision on the evidence. Here, the Department has presented evidence that the competitive environment is not sufficient to constrain prices and that, as a result, allowing Verizon upward pricing flexibility for existing services would not be reasonable. We have largely accepted that position. We can only speculate as to why the Department may have taken a position on legislation that is inconsistent with the factual evidence they have put forward here, but Verizon has presented no basis for ignoring that evidence.[162]

B. Pricing

1. Price Reductions at the Outset of the Plan and During the Plan

The Department has asserted that Verizon is overearning by $24 million.[163] Based upon that conclusion, the Department recommends that the Board reduce Verizon's retail rates in six areas:

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161. Verizon presented no evidence to show that basic rates in Vermont are priced below cost, such that a rate increase was necessary to facilitate competition.

162. We also note that the pricing flexibility advocated by the Department for the independent telephone companies was less than Verizon seeks. The legislation (now Section 227d of Title 30) limits the companies to a one-time nine percent rate increase. In addition, Section 218, which requires that rates be just and reasonable (i.e., cost-based) still applies to any rate increase, whereas Verizon proposes to operate without such a restraint. In a declining cost environment, it may be very difficult to make such a showing.

163. Department Brief at 8.

- Reducing intrastate special access rates[164] towards costs;
- Reducing switched access rates toward cost;
- Expanding local calling areas;
- Reducing local measured service usage rates toward cost;
- Reducing dial tone line rates for business basic exchange service; and
- Eliminating recurring charges for Nonpublished Service and Nondirectory Listed Service, or reducing the charges to incremental cost.[165]

In the alternative, the Department proposes that the Board could use the overearnings to offset the revenue losses associated with expanding local calling areas. The Department did not identify how the Board should allocate the rate reductions among these priorities, but instead left this determination to the Board.[166]

The Department also proposed a process whereby Verizon could avoid or defer $20 million of these rate reductions.[167] Under the Department's proposal, if Verizon deployed either DSL services in unserved areas or investments that increased network diversity, the Company could offset the amount of the rate reduction required for that year on a one-for-one basis.[168] For each year of the plan, the offset to rate decreases would be based upon the investments undertaken in the previous twelve months.

In addition, the Department proposed further rate reductions for each year of the Plan. These rate reductions, which are less than $2 million in each year, derive from the fact that Verizon's amortization of the expenses associated with past restructuring will phase out during the Plan.[169]

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164. These consist of Special Access Service, Superpath 1.544 Mbps Service, and direct trunked transport elements of Switched Access Service. Lackey pf. at 64.

165. Lackey pf. at 64–65.

166. Exh. DPS-LL-2; Department Brief, Appendix 2.

167. The Department did not clearly state what would happen with the remaining $4 million of its asserted overearnings. In its original testimony, however, the Department had advocated immediate rate decreases of $13 million, based upon its view that the excess earnings were approximately $33 million. We presume that the Department continues to support a $4 million immediate rate decrease.

168. Verizon would have the burden of demonstrating that its investment met the applicable criteria.

169. The Board made a similar adjustment in Dockets 6167/6189. Dockets 6167/6189, Order of 3/24/00 at 125–126.

In addition to its arguments that evaluation of its cost-of-service is inappropriate (which we discuss above in Section III.A.), Verizon maintains that the evidence shows that it is not overearning.[170] Moreover, Verizon argues that the Department's proposal is "more prescriptive" than the Incentive Regulation Plan and traditional regulation, since it attempts to prescribe how Verizon will invest.[171] Verizon characterizes the Department's Plan as an investment mandate, which is contrary to the premise of incentive regulation and which the Board has previously stated should not be adopted in an incentive regulation plan.[172] This investment mandate will also create stranded costs, since Verizon does not expect to profit from the investments.

Verizon also objects to the fact that the Department's plan only permits offsets if Verizon invests at least $40 million annually in other projects.[173] Finally, Verizon argues that the Department's proposal is based on what it calls the incorrect assumption that Verizon will not voluntarily invest adequately in the network. Verizon asserts that it has invested and will continue to invest at reasonable levels in its network.[174]

In Section III, above, we found that Verizon's earnings exceed just and reasonable levels by approximately $8.18 million annually.[175] In addition, the evidence shows that the completion of amortization of restructuring expenses over the term of the plan will increase these earnings further as the associated expense is removed from the regulatory books. As a result, Verizon must reduce its rates at the outset of the 2005–2008 Plan.

We do not fully accept the Department's proposal for the services that Verizon must reduce in price. Instead, Verizon should reduce Business Basic Exchange Service and intralata Message Toll Service at the outset of the plan, with the revenue reduction divided equally between these two services. For the price reductions in subsequent years, Verizon must reduce charges for Special Access Service, Superpath 1.544 Mbps Service, and direct trunked transport

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170. Verizon did not provide any recommendations for rate reductions if the Board did find that the Company's earnings were excessive.

171. Verizon Brief at 58–59.

172. Verizon Brief at 60–62.

173. Verizon Brief at 58–59.

174. Verizon Brief at 58–59; Porell reb. pf. at 29.

175. This figure assumes that Verizon elects to separate the Yellow Pages from the white pages as specified in the Proposed Order. If Verizon chooses to continue publishing and distributing the yellow and white directories together, the annual rate reductions increase by $7 million.

elements of Switched Access Service in 2006; either Message Toll Service or Residential Basic Exchange Service in 2007; and Residential Basic Exchange Service in 2008.

All of these rate reductions are directed to services that are less competitive and, therefore, less likely to decline during the term of the Plan. For example, Message Toll Service and Residential Basic Exchange Service reductions will have a greater benefit for low volume users — customers for whom alternatives such as VoIP are unlikely to be cost-effective.

We also accept, with modifications, the Department's proposed offset plan. That proposal would allow Verizon to retain the excess earning *if* it makes investments that will provide high value to Vermont residents — primarily in expanding the availability of broadband service. In fact, the most significant modification we find essential is to require that all investments for offsets be directed towards broadband deployment until Verizon has extended service to 90 percent of its customers.[176]

Verizon is correct that this mechanism creates a strong incentive for the Company to invest in extending broadband service and that the previous plan did not mandate investment — in fact, that is its intent. The primary reason we adopt this approach rather than simply relying upon the incentives created by alternative regulation is the experience of the last five years. As discussed previously, Verizon stated quite clearly that incentive regulation would create the appropriate incentives for the Company to provide broadband services to its customers. Notwithstanding those assurances, Verizon has been quite slow and limited in its deployment (until recently), so that customers seeking broadband options could only choose cable-based service. By contrast, nearly all of the independent telephone companies (which did not operate under incentive regulation, although they benefitted from some favorable federal financial support rules) have introduced broadband services and deployed it so that most customers had it available, with some reaching nearly 100 percent availability.[177] Against this backdrop, we are unpersuaded that, left to its own devices, Verizon will deploy broadband services to unserved areas during the course of the Plan. As a result, the Plan incorporates provisions to encourage such actions.

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176. This figure is consistent with the recommendations of the State Telecommunications Plan. Gabel pf. at 3.

177. Gabel pf. at 28.

The Department recommended that we define broadband service as 200 kbps both upstream and downstream.[178] Verizon, by comparison, stated that broadband service should be considered speeds of 1.5 megabits per second and above.[179] We accept Verizon's threshold, which will provide consumers with reasonable broadband speeds.[180]

Verizon is incorrect, however, in characterizing the offset as a mandate. Verizon has a choice; the Company can choose to lower its rates to just and reasonable levels, which is what the Proposed Order requires. Investment in broadband may be Verizon's preferred option, but we do not mandate it.

We also reject Verizon's argument that a minimum investment level is inappropriate. In part, Verizon's view is based upon an incomplete presentation of the past. Verizon correctly states that the 2000 Order did not set a minimum investment level. At that time, however, Verizon was under requirements from Docket 6150 to maintain existing investment levels through the end of 2003, which encompassed the majority of the Incentive Regulation Plan.[181] Including such a requirement in the Plan was unnecessary.

Irrespective of the prior Plan, the evidence here shows that an investment floor is appropriate. We have expressed our concern about Verizon's investment patterns in numerous places in this Order. In addition to those concerns, we note that, without a minimum investment requirement, Verizon would be able to reduce its normal investment in Vermont's infrastructure at the same time that it deploys broadband services. Since the capital for broadband under this Plan comes from money that would otherwise be returned to ratepayers, if Verizon reduced investment levels, ratepayers would unfairly be paying twice for the broadband expansion.

Finally, we are not persuaded by Verizon's assertion that the offset plan will create stranded costs. Verizon did not present sufficient evidence to show that, after the contribution provided through the offset mechanism, broadband deployment to unserved areas would still be uneconomic.

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178. Exh. DPS-LL-2.

179. Tr. 4/26/05 at 127–128 (Lacey).

180. We note that Verizon's threshold exceeds the speeds that it offers customers for some of its DSL products. Verizon should inform us if we have misunderstood Mr. Lacey's testimony concerning broadband speeds.

181. Docket 6150, Order of 9/13/99 at 48.

2. Pricing Flexibility

Findings

148. Some competitors, such as VOIP and wireless providers, do not have to file tariffs or wait 45 days before introducing new services. Nestor reb. pf. at 52; Porell reb. pf. at 23.

149. Permitting tariffs to become effective with short notice will allow Verizon to respond to customer needs and market changes in a timely manner. Nestor pf. at 8.

150. Verizon's existing 45-day notice requirement is the longest in the country and 50% longer than that in any other New England state. Porell reb. pf. at 24.

151. Verizon has committed not to deaverage its current statewide average retail rates on a geographic basis absent Board approval. Porell reb. pf. at 22–23; Vasington reb. pf. at 34.

Discussion

The expiring Incentive Regulation Plan provided Verizon with a degree of pricing flexilibity. In general, it capped prices on all existing services, with no rate increases permitted during the term of the plan. However, it provided Verizon substantial flexibility in the introduction of new services. Verizon remained free to introduce new services, to withdraw or grandfather the availability of those services, restructure the terms, and increase or decrease the prices for these new services. In so doing, the sole limitation that the Board adopted was the requirement that Verizon adhere to price floors, including those adopted in Docket 6077.[182] The Board also required Verizon to continue to file tariffs 45 days in advance of the effective date, as provided in Section 225 of Title 30, although the Board stated that, except in rare circumstances, it would not suspend such a tariff filing.

In its Alternative Form of Regulation Plan, Verizon proposes several changes to the pricing and tariff filing provisions. First, Verizon asks that the Board eliminate the 45-day advance notice for tariff filings and instead simply allow tariffs to take effect upon filing. Verizon maintains that such relaxation is necessary to allow Verizon to respond to competition

182. Brevitz pf. at 9.

and customer needs quickly.[183] Second, Verizon asks that, for most services, the Board allow the Company complete flexibility to introduce, modify, withdraw, and restructure services. Specifically, Verizon proposes to limit rate increases for residential basic services to 10 percent annually. Verizon also maintains that the only reason for limiting price increases for residential basic services is to preserve universal service.[184] Verizon considers the existing rates "affordable"[185] and proposes to increase lifeline benefits to match any residential basic rate increases.

The Company also states that it will not increase rates for wholesale services, such as switched access service used by competitors to provide toll. Finally, Verizon states that its rates should remain averaged during the term of the Plan. Verizon maintains that pricing flexibility is justified based upon market conditions, with competition now sufficient to restrain price increases.

The Department's proposal is akin to the existing Incentive Regulation Plan. Verizon would obtain flexibility to offer new services and special contracts without limitation (except the requirement that Verizon adhere to price floor rules). However, Verizon could not increase the rates for any existing services and would have to retain these services absent Board approval. The Department also recommends that we retain the 45-day notice period for new service offerings.

In the previous section, we concluded that present and reasonably anticipated competition was insufficient to prevent Verizon from increasing its prices. For this reason, we find the pricing flexibility set out in Verizon's proposal to be excessive and, therefore, unreasonable. In particular, Verizon has presented no evidence that would justify *upwards* pricing flexibility for existing services, such as a demonstration that the prices for certain services were below their total service long-run marginal costs. Nor has Verizon shown us why it is appropriate to allow such flexibility as long as services remain affordable. Higher rates may still be affordable for the majority of customers, but it is not clear how they would be just and reasonable.

183. Nestor pf. at 8; Brevitz pf. at 10.
184. Tr. 1/31/05 at 136 (Nestor).
185. Tr. 1/31/05 at 128–29 (Nestor).

Verizon has the view that under incentive regulation, the Board looks at the reasonableness of prices, not earnings. In part, we have accepted this paradigm and relaxed our review of earnings. Our disagreement with Verizon revolves around what constitutes reasonable prices. Here, unless Verizon can put forth a valid reason for increasing prices for consumers (particularly those subscribing to less elastic services), we decline to allow such upwards pricing flexibility.

Consistent with this view, in this Proposed Order, we adopt pricing terms and conditions substantially similar to those contained in the existing plan and recommended by the Department. Verizon must continue in effect existing services. The Company will have the flexibility to introduce new services and enter into special contracts without prior Board review and approval.

3. Notice

At the time we adopted the existing Incentive Regulation Plan, competition for Verizon existed primarily from CLECs. Under Vermont law, CLECs still must file tariffs 45 days in advance of the effective date (five days in advance for rate decreases).[186] Competition has since evolved; although facilities-based competition remains significant, wireless providers have expanded their services and offer more attractive competitive alternatives than previous. In addition, VoIP providers now offer a bundled local/usage package that did not exist at the time we adopted the previous plan. Neither wireless nor VoIP providers are required to file tariffs at the present time; similarly, they are not required to provide advance notice of new services.[187]

These changes in the marketplace persuade us that we should shorten the period between the filing of new services and their effective date. Verizon should be permitted to respond more quickly to new programs offered by its competitors. Accordingly, the Plan allows Verizon to have tariffs effective within ten business days of filing.[188]

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186. The Board may, pursuant to Section 227c, declare carriers such as the CLECs non-dominant and relax or eliminate the tariff filing requirements (as well as other statutory mandates). To date, the Board has not done so.

187. Tr. 1/31/05 at 91 (Porell).

188. The reduced notice period for Verizon gives the Company an advantage over other CLECs. This heightens the need for us to examine whether such carriers should be treated as non-dominant under Section 227c and to relax the notice period for them as well.

This shorter notice is not a panacea. The 45-day notice period cannot explain why it took over a year for Verizon to introduce new services here after they were rolled out in New Jersey. Even with the shorter notice period, Vermont ratepayers may benefit more slowly from new services than do customers in other states. However, shortening the notice period should place Verizon in a more equitable position relative to wireless and VoIP providers.

4. Geographic Deaveraging

At the present time, Verizon's rates are the same throughout its service territory. Verizon proposes to continue to average its rates during the term of the Plan. According to the Company, geographically averaged rates has the effect of providing to the rural areas the advantages of competitive pressures in urban areas.

The Department has put forth a proposal whereby Verizon could geographically deaverage its rates. Specifically, Verizon could obtain pricing flexibility in one or more specific geographic markets for specific services if the Board found competition sufficient.[189] Under the Department's proposal, the Board would need to hold further hearings to evaluate the market conditions in particular segments for which Verizon seeks flexibility.

This Proposed Order accepts Verizon's position. As we have explained above, competition in rural areas is extremely limited at the present time. Retaining the averaged prices ensures that these ratepayers benefit from any price decreases or new service offerings that Verizon institutes for customers in the more competitive urban areas.

5. Bundling of Services

Several of the new services that Verizon introduced during the Incentive Regulation Plan were bundles of existing services at discounted rates. These include plans such as the Local Calling Packages in which basic service is bundled with usage services to create a flat-rated option. More recently, Verizon has introduced packages that bundle intrastate services with unregulated services (such as broadband or wireless).

189. Lackey pf. at 77.

The Department expresses concerns with these new bundling options. According to the Department, absent conditions, the bundling of regulated and unregulated services could be unjustly discriminatory in violation of 30 V.S.A. § 218(a). The Department suggests that it could also be anticompetitive. As a remedy, the Department asks that the Board impose a condition that prohibits Verizon from varying the price of any intrastate service on whether the customer also purchases a non-jurisdictional service.[190]

Verizon opposes the Department's proposal. Verizon maintains that such bundling is permitted by Section 218(a), so long as Verizon reasonably allocates revenues. Verizon also points out that, as long as it meets the Board's price floor requirements, there is no issue of discrimination.[191]

We do not accept the Department's proposal. As Verizon points out, the legislature recently amended Section 218(a) by adding the following language:

> This section does not prohibit a telecommunications company from filing tariffs that condition the availability of an intrastate service upon subscription to an interstate or unregulated service from the same or an affiliated company; provided that an incumbent local exchange carrier shall provide a plan to allocate reasonable revenue between the regulated intrastate service and other services. The board retains the authority to review the tariff filing to determine whether it is just and reasonable.

This section clearly permits the tying arrangements to which the Department refers, as long as revenue is reasonably allocated. Implicitly, the revenue allocation provisions accept the premise that the bundling of these services may result in a reduction to the charges for intrastate services. The Department's proposal, while it does not directly conflict with the language of the statute, appears to be inconsistent with this intent. Moreover, the Department's proposal is inconsistent with the intent of bundling of services — i.e., that consumers receive a discount for purchasing both intrastate and other services. Accordingly, the 2005–2008 Plan contains no restrictions on bundling.

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190. Lackey pf. at 62–63; exh. DPS-LL-1 at 5.
191. Nestor reb. pf. at 51–52.

6. Price Floors

Findings

152. Price floors provide a safeguard to ensure that Verizon meets its wholesale obligations. Tr. 1/31/05 at 132–133 (Nestor).

153. Verizon will provide a price floor analysis whenever it proposes to change its tariffs. Tr. 1/31/05 at 147, 178 (Nestor).

Discussion

Over the years, the Board has taken many steps to establish and preserve a fair competitive framework, including the removal of barriers to entry, relaxation of licensing requirements, establishment of UNE rates based upon total element long-run incremental costs, and mandating price floors (and setting the rules for calculating such price floors). These efforts have led us to conclude previously that the market in Vermont is open to competition, as we discuss above.

In this proceeding, no party challenges these past requirements. Both Verizon and the Department rely upon these standards in their proposed alternative regulation plans, each of which specifically requires that all new and modified services that Verizon introduces must comply with price floors and include an analysis demonstrating such compliance.

Lightship, however, raised two concerns about the competitive framework. First, Lightship argued that Verizon's proposed plan could permit the Company to cross-subsidize more competitive services with less competitive ones. Because of this potential for anti-competitive behavior, Lightship recommends that the Board not approve any alternative regulation plan. Second, Lightship expressed concern about the manner in which Verizon used long-term special contracts to inhibit competition.[192] According to Lightship, Verizon has locked up many customers into such contracts, with significant early-termination penalties. Lightship asserts that Verizon waives these penalties when it (Verizon) enters into a new

192. Gawlick pf. at 2.

arrangement, a waiver that competitors cannot provide.[193] Lightship asks that the Board provide a one-year "fresh look" for these special contracts, during which all contracts could be renegotiated by any party without triggering the early termination penalties.

The existing Incentive Regulation Plan provided that Verizon must adhere to any price floor requirements set out by the Board, including the standards in Dockets 5713 and 6077. We find, as the Department and Verizon recommend, that we should retain this provision in the 2005–2008 Plan. Price floors, which require that Verizon price its services in excess of the cost that a competitor purchasing facilities from Verizon would face, are essential to fair competition. Accordingly, Verizon must continue to provide a price floor analysis with each tariff filing that it makes during the term of the Plan. That analysis shall be consistent with the standards that we have previously enunciated in Dockets 5713 and 6077.

In Docket 6167, we also stated the consequences of price floor violations:

> We conclude, therefore, that if Bell Atlantic is found to have priced below its floor, it must reduce other rates by an amount equal to the difference between the revenue generated at the price floor and the revenue produced at the contract or tariff price. Bell Atlantic must use this rate reduction to reduce rates for the less competitive services: residential exchange service.[194]

No party has recommended any change to this standard, which will continue to apply during the term of the Plan.

The changing nature of Verizon's wholesale service provisioning requires clarification of one aspect of the price floor requirement. Under past Board Orders, Verizon must calculate the price that it charges its competitors for wholesale services (primarily unbundled network elements), as well as any additional costs Verizon incurs. To the extent that Verizon offers services under commercial agreements rather than as mandated unbundled network elements, the price floor applicable to Verizon will change. The evidence presented during hearings shows that this will likely lead to a higher price for unbundled network elements provided under commercial agreements. For example, Verizon has offered local switching as an unbundled network element. Due to recent FCC Orders, Verizon is no longer required to offer this element

193. Gawlick pf. at 2–3.

194. Dockets 6167/6189, Order of 3/24/00 at 112 (footnote omitted).

at TELRIC prices, although Verizon has stated that it will still sell access to switching through commercial agreements. In developing its price floor for a new service, Verizon must include the price it charges competitors for local switching through these agreements.[195]

We are also concerned about Verizon's potential use of special contracts to restrict competition (although as we discussed above, we conclude that Verizon should continue to have the flexibility to enter into special contracts without prior review). Lightship's assertion that Verizon waives early termination charges when it renegotiates contracts could provide Verizon an unfair competitive advantage. A business facing an early termination charge must consider this cost when weighing the merits of an offer from a competitive telecommunications carrier. To ensure a level playing field, that business should face the same cost element when considering an offer for renegotiation of the contract from Verizon. We do not find it necessary to prohibit Verizon from waiving early termination charges, particularly since these may adversely affect the business customers, by delaying their ability to obtain lower rates. Instead, we require that, if Verizon waives early termination charges, the Company must include the waived amount in its calculation of the applicable price floor. This resolution will ensure that Verizon cannot selectively waive the early termination charges to benefit its own retail business.

With this price floor in place, we do not find it necessary to adopt a "fresh look" period as Lightship proposes. As Verizon has argued, many of the contracts (such as Centrex agreements) are associated with the deployment of facilities. These contracts are structured so that Verizon recovers its investment over the term. Early termination would unfairly prevent Verizon from obtaining full recovery.[196] More broadly, we find no basis for instituting a "fresh look" period now. Local exchange competition within the state has existed for nearly ten years. During that time, special contracts have expired; customers have had the opportunity to seek alternative arrangements from the competitors that exist in the marketplace. Companies such as Lightship have had the ability to solicit these customers. Lightship has not shown any particular practice

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195. It is possible that these agreements will include different prices for different competitors. Verizon would then need to include the highest price it charges for a particular element in its price floor.

196. Nestor reb. pf. at 87–89; Verizon Proposed Findings at 114.

that Verizon has imposed that would require us to abrogate these prior arrangements. As we explained in 1997:

> the market, though perhaps not competitive to the fullest extent, was nevertheless sufficiently competitive to offer [business customers] the protections that "fresh look" would otherwise provide. Had these customers lacked meaningful alternatives to the services of the incumbent LEC at the time they entered into their agreements, "fresh look" might very well be justified. As it is, however, I can see no reason to free these customers from the obligations that they knowingly took on.[197]

The same conclusion holds true today.

C. Infrastructure Deployment

Findings

154. Among the state telecommunications purposes are:

- Support the universal availability of appropriate infrastructure and affordable services for transmitting voice and high-speed data.
- Provide the benefits of future advances in telecommunications technologies to Vermont residents and businesses.
- Support competitive choice for consumers among telecommunications service providers.
- Support the application of telecommunications technology to maintain and improve governmental and public services, public safety, and the economic development of the state.

Campbell pf. at 4.

155. Significant areas of Verizon's territory do not currently have DSL or cable modem access to broadband service. Gabel pf. at 5–7.

156. Lack of access to broadband service will slow economic development in rural areas and contribute to social divisions between geographic areas. Gabel pf. at 7.

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197. Docket 5713, Order of 8/20/97 at 13 (citations omitted).

Discussion

Federal law specifically mandates that the states, including Vermont, are to encourage the deployment of advanced telecommunications services, including broadband services.[198]

Overall, the earnings freedom embodied in the Plan, as well as the flexibility to rapidly introduce new services and bundles, provide Verizon the same incentives that we established in the now-expiring plan. Verizon characterized these incentives favorably at that time;[199] we continue to hold that view. The 2005–2008 Plan set out in this Order does not, however, rely exclusively on investment expectations. First, to ensure that investment levels remain reasonable, we have adopted the Department's recommendation to institute a $40 million annual investment floor.

In addition, as we explain above, we accept in concept the Department's proposed mechanism by which Verizon can avoid required rate reductions by expanding broadband services and increasing network diversity. That proposal encourages investment both in new central office equipment and in equipment necessary to reach customers located beyond the 18-thousand-foot limit presently placed on DSL. Our Plan adopts the Department's proposal, with the modification that the extension of broadband is given much higher priority than diversity projects, that is, projects to provide alternate pathways for the transmission of telecommunications in order to avoid loss of service in an area due to equipment failure or casualty. We note that we recently approved a stipulation between the Department and Verizon that will devote $6 million in service quality penalties to diversity projects in Vermont.[200] Given that, we now consider the widespread deployment of broadband to be more urgent than the creation of diversity. Under the Plan set out below, therefore, diversity projects will not qualify as revenue reduction offsets until broadband is available to at least 90 percent of Verizon customers in Vermont.

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198. Section 706(a) of the Telecommunications Act of 1996.

199. Dockets 6167/6189, Order of 3/24/00 at 134.

200. Docket 6957, Order of 6/1/05.

D. Retail and Wholesale Service Quality

1. Retail Service Quality Issues

Findings

157. The Retail Service Quality Plan ("2000 Service Quality Plan") agreed to by the parties and adopted by the Board in Docket 6167 allowed the Board and the Department to monitor and evaluate Verizon's retail service quality performance in eleven areas over a five-year term. Docket 6167, Order of 3/24/00, Attachment D at Appendices A and B.

158. Performance areas include:

(1) Network Trouble Report Rate;

(2) Troubles Not Cleared within 24 hours-Residence;

(3) Troubles Not Cleared within 24 hours-Business;

(4) Average Speed of Answer-Repair Centers;

(5) Calls Not Answered within 20 seconds-Residence;

(6) Calls Not Answered within 20 seconds-Business;

(7) Busy Rate-Repair Centers;

(8) Percentage of Installation Commitments Not Met for Company Reasons-Residence and Business Total;

(9) Installation Held Orders Residence and Business Combined (Missed Installation Rate and Average Delay Days for Missed Installations);

(10) Service Reliability (consisting of Service Outage, Interoffice Facility Failure, and Signaling System Failure); and

(11) Network Congestion (a. Umbilical Blockage and b. Dial Tone Speed).

Docket 6167, Order of 3/24/00 at Attachment D.

159. The 2000 Service Quality Plan established baseline performance metrics for each of the eleven performance areas. Docket 6167, Order of 3/24/00 at Attachment D.

160. The 2000 Service Quality Plan calculated the compensation due to customers whose service has not met applicable standards by measuring the frequency of violations in each of the eleven performance areas. Docket 6167, Order of 3/24/00 at Attachment D.

161. In 2000, Verizon failed to meet the Busy Rate-Repair Center (3.1 performance compared to the standard of 3.0) and Dial Tone Speed (3 host/remote clusters with dial tone delay greater than 40%) performance standards. The compensation regarding the Busy Rate-Repair Center metric was waived by the Board due to a severe weather event. The failure to meet the Dial Tone Speed metric resulted in compensation to customers of $30,000. Alexander pf. at 11.

162. In 2001, Verizon failed to meet the Average Speed of Answer-Repair Centers (23 seconds versus the standard of 21 seconds or a 9.52% deterioration from standard) performance standard resulting in a compensation amount of $95,200. Alexander pf. at 11.

163. In 2002, Verizon again failed to meet the Average Speed of Answer-Repair Centers (31 seconds versus the standard of 21seconds or a 47.62% deterioration from standard) performance standard and also failed to meet the Troubles Not Cleared within 24 hours-Residence (37.6% compared to 30%) metric. These failures resulted in a compensation amount of $970,000. Alexander pf. at 12.

164. In 2003, Verizon failed to meet the performance standards in five areas: (1) Troubles Not Cleared within 24 hours- Residence (75% deterioration from the baseline standard); (2) Troubles Not Cleared within 24 hours-Business (44% deterioration from the baseline standard); (3) Average Speed of Answer-Repair Centers (109% deterioration from the baseline standard); (4) Busy Rate-Repair Centers (10% deterioration from baseline standard); and (5) Installation Held Orders Residence and Business Combined (29% deterioration from standard). These failures resulted in compensation in the amount of $8,085,634. Alexander pf. at 12.

165. In 2004, Verizon failed to meet the Troubles Cleared within 24 hours-Business resulting in compensation of $835,000 (1.2% deterioration from standard). Exh. DPS-34; Nestor reb. at 6.

166. State-level data reported to the FCC by Verizon also reflect a trend in performance deterioration with respect to repair intervals, increases in subsequent trouble reports, and increases in repeat trouble reports. Alexander pf. at 16.

167. In 2004, Verizon added additional work force to reduce the duration of trouble repairs and missed appointments, new technology to speed up and prioritize incoming calls at the repair

call centers, and additional engineering and construction work designed to reduce installation delay days and improve repair metrics. Alexander pf. at 14–15.

168. Existing and future competition for local exchange service and other telecommunications services alone will not substitute for a regulated approach to retail service quality. Alexander pf. at 17–19.

Discussion

Verizon argues that its overall performance under the 2000 Service Quality Plan has been "good."[201] Verizon points out that of the 90 service quality measurements it has been required to meet it has only failed with respect to 12. Verzion also states that the major driver of penalties under the Service Quality Plan, the repair center speed of answer metric, has been corrected.

Verizon contends that competition in the local exchange market and technological change have made the Service Quality Plan no longer necessary.[202] Verizon believes that customers unhappy with its service quality can take their business to other local exchange carriers, VoIP providers or wireless carriers. Verizon also argues that recent technological changes and alternatives have made many service quality metrics obsolete.

Finally, Verizon argues that many states have eliminated or modified their service quality penalties in response to marketplace competition and changes in technology.[203] Verizon also argues that the penalty provision associated with the 2000 Service Quality Plan requires Verizon to put at risk an unreasonably high amount of intrastate revenue when compared to other New England states.[204] Similarly, Verizon believes that the 2000 Service Quality Plan service penalties are significantly higher than comparable penalties for service failures in other New England states.[205]

201. Nestor reb. pf. at 5–6.
202. Nestor pf. at 18-19.
203. Brown reb. pf. at 9.
204. Tr. 4/27/05 at 92 (Nestor).
205. Nestor reb. pf. at 12.

In the case that the Board determines it is necessary to include a Service Quality Plan in the alternative regulation plan, Verizon has submitted its own proposal.[206] Verizon's proposed service quality plan includes eight service quality metrics covering network performance, maintenance service and installation service. The plan assigns points, on a monthly basis, based on Verizon's performance under the metrics. Verizon would be required to achieve a certain level of points in each month. Failure to achieve a certain level of service quality in a given month would result in Verizon filing a Performance Improvement Plan ("PIP") addressing the specific areas requiring improvement, but Verizon would not be required to pay compensation dollars or other penalties.[207] The PIP would describe the specific corrections actions implemented by Verizon in response to the service quality failures.

The Department argues that Verizon's performance under the 2000 Service Quality Plan has deteriorated in several areas.[208] The Department points out that in each of the years 2000 through 2003 both the number of metrics missed and the amount of penalty dollars owed by Verizon increased. The Department also notes that Verizon has missed the same metrics in successive years. The Department believes that Verizon's service quality failures under the 2000 Service Quality Plan evidence the continuing need for retention of service quality standards as a condition of earnings and pricing flexibility.

The Department contends that a successor service quality plan is a necessary part of an alternative regulation plan because the state of competition for local exchange service is not sufficient to ensure adequate service quality to Verizon's customers.[209] The Department argues that while competitive alternatives, such as VOIP or wireless service, are available to many customers, these options are not universally available in Vermont, and are often more expensive than basic local exchange service. Further, in areas where competitive local exchange carriers exist, customers will, in many cases, be unable to improve their service quality by switching to another provider because the competitive provider is likely to rely on the underlying facilities of Verizon. Finally, the Department argues that most of the New England states have imposed a set

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206. Nestor pf. at 19 and Attachment E.
207. Nestor pf. at 25–27.
208. Alexander pf. at 10–12.
209. Alexander pf. at 17–19.

of service quality standards as part of an alternative regulation plan. All of these states have adopted specific service quality standards that include predetermined penalties or customer credits for service quality failures.[210] Therefore, if Vermont no longer requires a Service Quality Plan with penalty dollars attached, it is likely that Verizon would give priority for investment in service quality to states that have Service Quality Plan's with penalties. The Department believes that as a rural state that is a small part of a large incumbent carrier's territory, Vermont must have a regulatory scheme with significant penalty dollars at stake in order to "get the corporate attention of" Verizon.[211]

The Department supports the current structure and content of the 2000 Service Quality Plan.[212] The Department also recommends that the Board modify the 2000 Service Quality Plan to reflect actual experience with the Service Quality Plan, recent developments in performance area measurement protocols, and approaches adopted in other states. Specifically, the Department recommends (1) modification of the Interoffice Facility Failure metric, (2) addition of two new sub-parts to the Network Trouble Report Rate metric, (3) modification of the Average Delay Days sub-part of the Installation Orders Held metric, (4) modification of the Repair Center performance metric; and (5) addition of a Complaint Rate metric.[213] The Department also believes that Verizon's PIP is a reasonable proposal and recommends including this provision as part of the successor Service Quality Plan in addition to the existing and new performance measures it has proposed.

In adopting the 2000 Service Quality Plan, the Board stated that its:

> acceptance of many aspects of the incentive regulation proposal, such as forbearance of future pricing issues, elimination of earnings regulation, and relaxation of many filing requirements are directly linked to, and directly reliant upon the understanding that customer service quality will be maintained or enhanced.[214]

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210. Alexander pf. at 19–20.
211. Tr. 4/27/05 at 191–92 (Alexander).
212. Alexander pf. at 25–27.
213. Alexander pf. at 28–33; Frankel pf. at 12–13, 17–18.
214. Docket 6167, Order of 3/24/00 at 145 (footnote omitted).

Further, the Board stated that "[f]ailures in this area could significantly influence our exercise of discretion to reopen" the Incentive Regulation Plan.[215] Verizon argues, among other things, that its performance under the 2000 Service Quality Plan has been "good" and therefore an indication that a successor service quality plan is not necessary. Verizon's performance as measured by the 2000 Service Quality Plan does not support that conclusion. Rather, Verizon's performance has shown a pattern of deteriorating service quality.

In 2000, Verizon essentially met the standards in the plan with the exception of two metrics: Busy Rate Repair Center and Dial Tone Speed. The penalty for Busy Rate Repair Center was later waived by the Board due to severe weather. As a result, Verizon paid only $30,000 in compensation to ratepayers in 2000. Similarly, in 2001 Verizon missed only one metric, Average Speed of Answer for Repair, by only two seconds. Verizon was assessed a penalty of $95,200. Although Verizon failed to meet two metrics over two years, its performance did not reveal any signs of serious service quality deterioration. However, in 2002, Verizon again failed to meet the Average Speed of Answer for Repair and also failed to meet Troubles Not Cleared within 24 hours-Residence. Not only did Verizon miss the Answer Repair metric two years in a row, but it missed the metric by substantial margin instead of the 2 seconds it missed by in 2001. Verizon's performance on other metrics, while not failures, also deteriorated. As a result, Verizon paid compensation in the amount of $970,000. In 2003, Verizon failed to meet a total of five metrics. Once again Verizon missed the Answer Repair metric, this time by 23 seconds. More troubling, Verizon also missed Troubles not Cleared-Business and Residential, Busy Rate and Installation Held Orders metrics. The penalties associated with these service quality failures were over $8 million. In 2004, Verizon again missed the Troubles not Cleared-Business metric, resulting in $835,000 in penalties.

Verizon's performance under the 2000 Service Quality Plan viewed in terms of the increasing amounts of number of metrics missed, the amounts those metrics were missed by and the penalty amounts, has clearly deteriorated from the outset of the 2000 Service Quality Plan. Further, Verizon missed the same metric, Answer Repair Centers, three successive years and remedied this problem only after the penalties became substantial. Verizon's performance over

215. Docket 6167, Order of 3/24/00 at fn. 505.

the term of the 2000 Service Quality Plan has not shown the level of "maintenance and enhancement" of service quality that the Board envisioned when it adopted the plan in Docket 6167. Therefore, the Board concludes that Verizon's poor performance does not merit exclusion of service quality standards in a successor alternative regulation plan.

In Docket 6167, the Board stated that "for basic telecommunications services for which there are few or no competitive alternatives, it is essential that [Verizon] maintain the quality of its services."[216] Verizon argues that these competitive alternatives, in the form of VoIP and wireless services, have now arrived and service quality standards are, therefore, unnecessary. As discussed in detail above in Section V.B., we do not find that competition in local exchange telecommunications is as robust as described by Verizon. In addition, even if the competitive alternatives described by Verizon were widely available, the cost of these products and the rural nature of the state will prevent many customers from being able to utilize these alternatives. VoIP requires the customer to purchase some type of broadband connection in addition to purchase of the VoIP service itself. The relatively greater cost of this product will make this alternative too costly for many customers. Low population density and mountainous terrain will continue to make it difficult for many customers to receive wireless service in their communities. The existence of competitive alternatives alone will not necessarily substitute for service quality standards.

Moreover, Verizon's performance over the last five years belies its assertion that competition is sufficient to protect service quality. Competition has clearly increased during this period, yet Verizon's service quality performance deteriorated. Unless we accept the premise that consumers must accept lesser service quality in a competitive market,[217] which we do not, we can only explain this dichotomy by inferring that competition does not provide adequate restraint.

We also find Verizon's argument, that because other states have eliminated service quality plans or have lower penalty provisions Vermont should follow suit, unconvincing. As the Department points out, most of the New England states have imposed a set of service quality

216. Docket 6167, Order of 3/24/00 at 145.

217. Competition is intended to benefit consumers by forcing prices closer to long-run marginal cost and by having companies compete to offer new services and high quality. Decreasing service quality undermines this value (at least in part).

standards that include predetermined penalties or customer credits for service quality failures. The Service Quality Plan that we adopt is consistent with these other programs. We conclude that Vermont's status as a relatively small part of Verizon's territory requires a service quality plan with significant penalty dollars attached in order to achieve its purpose of maintaining adequate service quality. Unless the plan contains a strong incentive for Verizon to keep its service quality high, there is too much risk that verizon will not take steps to preserve service quality and treat the payments as a cost of doing business. Such a course benefits neither Verizon nor consumers. The penalty dollars in the 2000 Service Quality Plan, which we retain, should provide a strong inducement for Verizon to maintain high service quality.

Based on Verizon's performance under the 2000 Service Quality Plan and the state of competition in Vermont, the Board concludes that inclusion of a Retail Service Quality Plan is necessary to insure adequate service quality and, therefore, an integral part of an alternative regulation plan. The Service Quality Plan we adopt here is based largely on the 2000 Service Quality Plan with some exceptions as noted below.

We adopt the Department's recommendation concerning the Average Speed of Answer-Repair Centers performance area. Currently this metric measures the average speed of answer, in seconds, by a service representative of all repair calls during an annual period. Because Verizon now uses an automated system to handle these calls this metric is no longer applicable. The Average Speed of Answer-Repair Centers would be replaced with a standard that will require Verizon to answer an average of 80% of calls from customers who seek to speak to a live customer service representative for both the repair and business offices within 20 seconds. This will be combined with the Busy Rate-Repair Centers performance metric to create one new Repair Center metric. The Busy Rate metric measures the percentage of time customers encounter a busy recording or signal when calling the repair centers. The new Repair Center performance area will be comprised of these two sub-parts with each worth one-half of the performance measurement.

The Department has also proposed modification of the Service Reliability performance area. This performance area contains three categories of service failures: (1) Service Outages;

(2) Interoffice Facility Failure; and (3) Signaling System Failure. The Interoffice Facility Failure category measures interoffice call blockage impacting 30,000 access lines for more than 30 minutes. The Department believes that the 30,000 line threshold is too great to reflect the majority of interoffice failures and is, therefore, not a meaningful measure. The Department suggests lowering the 30,000 line threshold to 4,000 lines to make the standard more relevant. However, the Department also states that Verizon should be able to obtain a waiver of any penalties under this section if it makes the Department's suggested investments in network diversity.[218]

The Board declines to adopt the Department's recommendation with respect to the Interoffice Facility metric. The Board has recently approved an agreement between the Department and Verizon that would greatly increase the amount of Verizon's network diversity in the near future.[219] These projects address a substantial number of instances in which remote central office/host remote interoffice routes lack diverse interoffice transport. After the completion of the projects, the number of offices with diversity will increase from 11 to 37, resulting in approximately 61% of Verizon's access lines in service being served by diverse routes.[220] This additional network diversity should address many of the problems described by the Department as the basis for increasing the scope of the Interoffice Facility metric. Therefore, revision of this metric is unnecessary.

The Department also recommends adding new standards under the existing performance areas of Installation Held Order Rate and Network Trouble Report Rate.[221] In addition, the Department recommends adding a new performance area to measure the consumer complaint rate.[222]

Again, the Board declines to adopt these new standards. Adopting the additional metrics proposed by the Department without any change to the penalty dollars at stake will increase the likelihood of triggering the penalty provisions by virtue of increasing the amount of penalty

218. Frankel pf. at 20.
219. Docket No. 6957, Order of 6/1/05.
220. Docket No. 6957, Order of 6/1/05, at 5–6.
221. Alexander pf. at 28–31.
222. Frankel pf. at 12.

points possible. The Department has not persuaded us that particular aspects of service quality are so important as to require alteration of the balance in the Service Quality Plan by increasing the likelihood of penalties. Absent a strong showing that these metrics are essential, or an adjustment to the penalty point calculation that would reduce the overall effect of the new metrics, it would be unfair to Verizon to add the additional penalty points without a commensurate adjustment to the size of total compensation dollars available. Because the Department has not suggested adjusting the size of the compensation cap or the compensation point calculation method, we decline to add these new metrics or sub-parts.

We also decline to adopt a PIP provision as part of a successor Retail Service Quality Plan as suggested by the Department. The Board agrees with Verizon that, in lieu of penalty dollars, the submission of a PIP would be a useful tool. However, because the Retail Service Quality Plan we have adopted includes penalty provisions, that is not the case here. The Board believes that a Retail Service Quality Plan that includes compensation to customers for specific service quality failures should provide the necessary incentives to Verizon to develop a means to improve service in areas in which it has incurred penalties and, therefore, a PIP is unnecessary.

2. Wholesale Service Quality

Verizon's wholesale service quality is currently measured by Carrier to Carrier standards of performance that govern Verizon's wholesale service offerings and a Performance Assurance Plan ("PAP") that comprises the mechanism for ensuring that Verizon will attain those standards.[223] These wholesale service quality standards and enforcement mechanisms exist separately from the retail service quality and are not part of Verizon's existing Incentive Regulation Plan. The Department recommends that these wholesale standards be incorporated by reference into the successor alternative regulation plan.[224] The Department notes that Verizon has asserted that its compliance with the PAP is discretionary. The Department argues that without a PAP in place, Verizon could allow wholesale service quality to deteriorate to the point of discriminating against its competitors. Incorporation of the PAP into the successor

223. Docket No. 6533, Order of 2/2/02 at 6–7.

224. Lackey pf. at 83–84.

alternative regulation plan would, the Department argues, necessitate reconsideration of the plan in the event Verizon proposes to withdraw the PAP or allows wholesale service quality to significantly decline.

Verizon recommends that the Board reject the Department's plan to incorporate the wholesale service quality standards into a successor alternative regulation plan.[225] Verizon believes that the current process which involves centralized carrier to carrier negotiation of PAP standards for multiple states and subsequent adoption by the Baord of the standards is working adequately. Verizon argues that there is no evidence to suggest that Verizon will propose to eliminate the PAP and that any major PAP modification would be brought before the Board.

The Board agrees with the Department that wholesale service quality standards and enforcement mechanisms are important elements in ensuring fair treatment for Verizon's competitors in Vermont. However, it is not necessary to include those measures as part of the alternative in order to ensure their continued existence. Verizon introduced the PAP as part of its commitments to the State of Vermont in its application to the FCC for authorization under Section 271 of the Act to offer long distance service. We expressly relied upon Verizon's commitment when we made our recommendation to the FCC. At the time we originally approved the PAP, in Docket 6533, we explicitly noted that we had the authority under state law to mandate revisions to the PAP.[226] Thus, we consider the PAP a binding commitment by Verizon.

Moreover, in Docket 6255, we also made it clear that we retain the authority to investigate specific instances in which Verizon's wholesale service quality might be inadequate.[227] In addition, in the instant docket, Verizon concedes that any major modification or revision to the PAP will need to be reviewed and, presumably, approved by the Board. Therefore, we decline to include the PAP in the 2005–2008 Plan.[228]

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225. Nestor reb. pf. at 54–56.
226. Docket No. 6533, Order of 2/2/02, at 7 (footnote omitted).
227. Docket No. 6255, Order of 4/15/04 at 7.
228. If Verizon seeks to withdraw or substantially modify the PAP, we may need to reevaluate this issue.

E. Term of Plan

Both parties have proposed plans of three years' duration, with provisions for extension up to four more years. The Plan approved in this Proposed Order is a three-year plan consistent with the parties' approvals. Considering the rapid changes in certain portions of the telecommunications market and the possibility that more direct competition from cable services will begin within a few years, a three-year plan is reasonable.

We do not at this time take any position as to possible extensions. Neither party has provided evidence sufficient for us to approve a plan that would be in place for seven years. If any party seeks to extend the plan, we will consider the merits of continuing this plan at that time. We will then know more about how Verizon actually responds to the incentives of this plan; we will also have the results of the depreciation study we have ordered today.

F. Monitoring of Plan

Findings

169. The Board established a Performance Benchmark Report in approving the existing Incentive Regulation Plan in Dockets 6167 and 6189. The report contains three sections: physical facilities and network infrastructure; prices; and service availability. Docket 6167, Order of 3/24/00 at 152–153.

170. The Board also established a UNE Tracking Report as a means of tracking the wholesale costs and revenues of unbundled network elements as part of the alternative regulation plan. Dockets 6167/6189, Order of 3/24/00 at 25.

171. It is necessary for the Board to monitor Verizon's performance as a means of judging the effectiveness of a successor alternative regulation plan. Brevitz surr. pf. at 49–50.

172. The existing Performance Benchmark and UNE Tracking Reports should be modified to better reflect Verizon's performance in key areas. Docket No. 6167, Order of 3/24/00 at 50–52.

Discussion

Verizon argues that due to technological changes and increased competition, the majority of the information provided in the Performance Benchmark Report is "no longer relevant to assessing the effectiveness of an alternative regulatory plan."[229] Verizon suggests that, instead of the Performance Benchmark Report, the Company file an annual marketing report that lists tariff changes and new product and services offered across the New England region.[230] Verizon contends that any additional financial or network information that the Board might need can be obtained through review of the ARMIS data that is currently filed with the FCC annually.

The Department contends that the Performance Benchmark Report is a necessary means of monitoring Verizon's performance.[231] Therefore, the Department argues, the report, with certain modifications, should be retained in a successor alternative regulation plan.[232] Specifically, the Department suggests elimination of statistics regarding Verizon's former-GTE operations, any line items which show 100% deployment or availability, and other non-useful line items. The Department also suggests the addition of several line items to reflect the prices and take-rates of bundled service offerings, a breakdown of local revenue per access line into business and residential, the take-rate for DSL service and the percentage of DSL-qualified loops.

The Department has also suggested several revisions to the UNE Tracking Report. The modifications would require reporting of volumes and revenues by urban, suburban, and rural zones. The modifications would also require more information regarding commercial agreements for unbundled network elements.

Pursuant to 30 V.S.A. § 226b(d):

> Prior to approving, modifying, or renewing an alternative form of regulation with respect to a specific basic exchange telecommunications provider, the board shall establish, and may amend form time to time, standards and procedures by which the effectiveness of the alternative form of regulation can be determined.

In order to meet its statutory obligation to evaluate the effectiveness of the existing Incentive Regulation Plan, the Board required Verizon to provide a series of reports over the term of the existing plan. In order for the Board to continue to meet its statutory obligation, it is necessary to continue this reporting requirement. Therefore, Verizon shall continue to provide the

229. Nestor reb. at 60.

230. Nestor reb. at 60-61.

231. Brevitz surr. pf. at 49-50.

232. Brevitz surr. pf. at 50-51.

Department and the Board with the reports, as modified herein, regarding construction, financial, and service quality that it now files, over the term of the successor alternative regulation plan. Modifications to the construction, financial, and service quality reports are discussed in the sections corresponding to those headings above.

We agree with both Verizon and the Department that much of the information provided pursuant to the Performance Benchmark Report is no longer relevant. However, the report, especially with the modifications suggested by the Department, is still an important part of evaluating Verizon's performance under a successor alternative regulation plan. Therefore, we adopt (on a preliminary basis) the modified Performance Benchmark Report (as described by the Department) as part of the 2005–2008 Plan.

The modifications to the UNE Tracking Report suggested by the Department also appear to be reasonable. The FCC's rules governing provision of UNEs have recently been largely vacated by the DC Court of Appeals.[233] Given the uncertainty surrounding the provision of UNEs, it is likely that competitive carriers will increasingly seek to procure UNE-Platform and UNE-Platform-like arrangements through commercial agreements with Verizon.[234] These modifications will allow the Board to better monitor these commercial agreements over the course of the successor 2005–2008 Plan. Therefore, we adopt the modified UNE Tracking Report as described by the Department.

While we adopt these modified reports at this time, we do so on a preliminary basis. Before we adopt the final reports, we wish to solicit input regarding the specific elements of the modified reporting requirements. We, therefore, request that the Department distribute the new report forms (consistent with its proposal) to the Board and the other parties within thirty days of the issuance of the final Order in this proceeding. Parties may file any comments regarding the modifications within forty-five days of the final Order. We also invite comment as to whether the Board should conduct a workshop regarding the modified reporting requirements before we issue a final ruling.

233. Brevitz pf. at 32-33.
234. Brevitz pf. at 32-33.

VI. Statutory Analysis

Findings

Promotion of the General Good:

173. The 2005–2008 Plan adopted by the Board in this Order will promote the general good. Findings 1–168.

Consistency with 30 V.S.A. 202c:

174. The 2005–2008 Plan is consistent with Vermont's telecommunications purposes under 30 V.S.A. § 202c. It maintains affordable rates for basic service, provides incentives for further deployment of high-speed data services, prescribes standards for continued high quality of service, and provides appropriate incentives for promoting a modern infrastructure. Findings 1–172.

Consistency with the Vermont Telecommunications Plan:

175. The 2005–2008 Plan is consistent with the Department's Telecommunication Plan. In general, the relevant elements the Telecommunications Plan sets forth for evaluating whether an alternative regulation plan is consistent are recognition of the state of competition, expectations for network modernization and investment, inclusion of a service quality plan, and allows for pricing flexibility and bundled service offerings. Findings 1–168; Campbell pf. at 12–13.

Service Quality:

176. The 2005–2008 Plan is consistent with the public's interest relating to appropriate service quality. The retail service quality plan included as part of the 2005–2008 Plan creates adequate incentives for provision of high quality service. Findings 157–168; *see*, Section V.D; Attachment C to the Plan.

Universal Service:

177. The 2005–2008 Plan is consistent with the goal of protecting or promoting universal service to residential users of telecommunications services. Findings 1-168.

Telecommunications Infrastructure:

178. The 2005–2008 Plan provides reasonable incentives for investment in a modern telecommunications infrastructure and implementation of new cost-effective technologies by

providing direct financial incentives for Verizon to invest in broadband capable facilities. Findings 1–168; Lackey pf. at 81–82.

Economic Development:

179. The 2005–2008 Plan reasonably supports economic development in Verizon's service territory by assuring Verizon's telecommunications services are available to its customers at just and reasonable rates. Findings 1–168.

Protection of Consumer Privacy Interests:

180. The 2005–2008 Plan adequately protects consumer privacy interests. Attachment B at 3.

Competition:

181. The 2005–2008 Plan supports reasonable competition. *See*, Section V.B., above.

Competitive Safeguards:

182. The 2005–2008 Plan includes adequate safeguards to insure that charges for non-competitive services do not subsidize competitive services. These include price floor requirements that preclude Verizon from offering any service at a level that would require a subsidy. *See*, Section V.B, above; Lackey pf. at 84–85.

Fairness:

183. The 2005–2008 Plan is just and reasonable and will not produce unjust discrimination between users of the public switched network in the pricing, quality or availability of the network functions or services offered. *See*, Section V.B., above.

Discussion

We conclude that the 2005–2008 Incentive Regulation Plan satisfies the criteria set out in 30 V.S.A. § 226b.

VII. Conclusion

The 2005–2008 Incentive Regulation Plan that we set out in this Proposed Order largely continues the regulatory regime that we adopted five years ago. The alterations that we have made reflect changing circumstances and our experience over the last five years. The Plan creates incentives for Verizon to deploy new services and invest in new technologies, particularly by permitting Verizon to retain any additional earnings it derives from such actions. At the same time, it preserves essential protections for ratepayers, such as the Service Quality Plan.

VIII. PROPOSED ORDER

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED by the Public Service Board of the State of Vermont that:

1. The 2005–2008 Incentive Regulation Plan, as discussed in this Proposed Order (and set out in Attachment B to this Proposed Order), is approved, effective July 1, 2005.

2. Within 15 days of the Final Order, Verizon New England Inc., d/b/a Verizon Vermont ("Verizon") shall file tariffs with rate reductions consistent with this Proposed Order.

3. Verizon shall comply with the reporting requirements set out in Section V.F. of this Order.

4. Within 30 days of the Final Order, the Department of Public Service ("Department") shall file a revised format for the Performance Benchmark and Unbundled Network Element Tracking Reports. Other parties may submit comments on these formats within 15 days of the Department's filing.

5. Verizon shall comply with all other directives in this Order.

Dated at Montpelier, Vermont, this _________day of _______________, 2005.

______________________________)
) PUBLIC SERVICE
)
______________________________) BOARD
)
) OF VERMONT
______________________________)

OFFICE OF THE CLERK

FILED:

ATTEST:____
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: Clerk@psb.state.vt.us)

Appendix A — Parties

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National Mobile Communications Corp., d/b/a SoVerNet Communications
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